



Organización Internacional de Comisiones de Valores
International Organisation of Securities Commissions
Organisation internationale des commissions de valeurs
Organização Internacional das Comissões de Valores

December 2, 2010

Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, NY 10017

Re: Proposed International Standards on Auditing 315 (Revised), “Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment” and 610 (Revised), “Using the Work of Internal Auditors”

Dear Mr. Sylph:

The International Organization of Securities Commissions (IOSCO) Standing Committee No. 1 on Multinational Disclosure and Accounting (SC 1) appreciates the opportunity to comment on the Exposure Draft (ED) of proposed International Standards on Auditing (ISA) 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* and ISA 610 (Revised), *Using the Work of Internal Auditors*. As an international organization of securities regulators representing the public interest, IOSCO is committed to enhancing the integrity of international markets through promotion of high quality accounting, auditing and professional standards.

Members of SC 1 seek to further IOSCO’s mission through thoughtful consideration of accounting, auditing and disclosure concerns, and pursuit of improved global financial reporting. We direct our attention to professional standards that relate to auditing of financial statements contained in documents filed with securities regulators or otherwise made available to the general public. As we review proposed auditing standards, our concerns focus on whether the standards are sufficient in scope and adequately cover all

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concerns focus on whether the standards are sufficient in scope and adequately cover all relevant aspects of the area of audit being addressed, whether the standards are clear and understandable, and whether the standards are written in such a way as to be enforceable. Our comments in this letter reflect those matters on which we have achieved a consensus among the members of SC 1; however, they are not intended to include all comments that might be provided by individual members on behalf of their respective jurisdictions.

Views on Certain Key Issues in the Exposure Draft

Purpose of the Project

We welcome a project to update ISA 610 and provide additional coverage of how external auditors can appropriately and effectively use the work and information provided by a company's internal audit function to enhance the quality of an audit. We can appreciate the challenging task of revising an international standard given that there is a diverse range of practices around the world. Within SC 1, our members' jurisdictions have varying practices regarding the use of internal audit by external auditors, particularly in regard to direct assistance.

In this comment letter, we outline several matters that we believe need to be addressed before the revisions to ISA 315 and ISA 610 are finalized. Some comments relate to clarifications needed, while others relate to additional content that is needed to address gaps that we believe exist in the requirements and/or application section of the proposed standard.

We recall that during discussions at previous CAG meetings mention was made of the concerns of regulators and users that use of a company's internal audit function should not simply be a cost cutting measure. To this end, we would be extremely concerned if the motivation for using internal audit work was tied to a desire for cost reduction on the part of either the issuer or the external auditor, rather than viewing use of internal audit as a tool to enhance audit quality. We believe it would be helpful for the Introduction in ISA 610 to state that the auditor's judgment regarding use of internal audit should be based upon a conclusion that such use will contribute to audit quality.

Preserving the Principle of an Independent External Audit

We believe that information provided by a competent and objective internal audit function can provide valuable insight into an audited entity's business and be useful to an external auditor in assessing and addressing the risks of material misstatement in a financial statement audit. However, we caution that an external auditor's use of the internal audit function cannot be of a nature and extent that would be perceived by investors and other reasonable third parties to undermine the concept of "an independent external audit."

We recognize that internal auditors can add to the quality of an audit because they often have valuable inside knowledge of the business, organization, and risks of the audited

entity. However, in the interest of high quality audits and investor confidence, it is important that there is a clear distinction between the roles of external auditors and internal auditors and that the "independent external audit" is the product of the external auditor's work. As such, external auditors must themselves perform sufficient procedures in gathering and corroborating audit evidence in order to fulfill the external auditor's full responsibility for the audit opinion.

Because internal auditors are employees of the audited entity, they cannot by definition be considered independent in the sense that is required for members of an external audit engagement team. Therefore any use made of internal audit employees and/or their work in the internal audit function must be made with careful evaluation of their competency and objectivity, as well as with safeguards and with professional skepticism on the part of the external auditor.

We have a concern if an external auditor makes use of such internal audit work without assessing internal audit's qualifications in the way that would be comparable to work done when using the work or reports of component auditors in an external audit. In particular, we would encourage the IAASB to include some mention in ISA 610 paragraphs 13 and 14 of the factors that should be evaluated by the external auditor in assessing objectivity and competence in an internal audit function. In addition to mentioning the factors that are now covered only in Application Material paragraph A6, the coverage should address points such as whether the internal audit function possesses an understanding of the relevant external auditing standards applicable to their work sufficient to fulfill the internal audit function's responsibilities relating to the external audit; and whether the internal audit function possesses the special skills (for example, industry specific knowledge) necessary to perform the work related to the financial statements. Also, the related Application Material paragraph A6 of ISA 610 might also describe the independence requirements applicable to external auditors, to add emphasis as it discusses the importance of objectivity on the part of internal auditors.

External auditors should not rely on internal auditors with respect to the performance of significant substantive procedures nor should the work of, or information supplied by, the internal audit function be the sole source of audit evidence in any area of the audit that is more than low risk or is otherwise significant to the audit. Using the work of internal audit in any way that could potentially cause such work to be substituted for external audit procedures to an inordinate degree, or that could lead to accepting such work without the professional skepticism that would be applied to information supplied by other employees of the audited company is unacceptable. We would be very concerned if overuse or inappropriate use was made of information or work of the internal audit function.

To this end, paragraphs 18, 19 and A17 of ISA 610 should be supplemented with additional safeguards for using the work of internal audit in partial substitution for audit evidence to be gathered directly by the external auditor. Safeguards should include all of the following:

1. For work performed by internal audit that is to be relied upon by the external auditor, the external auditor should independently reperform procedures and be satisfied that there is minimum variation of the results.
2. The totality of procedures performed by internal audit and used by the external auditor should not be material to the financial statements of the audited entity.
3. Work performed by internal audit and relied upon by the external auditor should not include matters that involve high risk or a high need for judgment.

Paragraph 19 of ISA 610 addresses the external auditor's evaluation of the adequacy of audit work after a decision has been made to use such work. We believe that mention should also be made of assessing the apparent objectivity of the work performed.

Various Uses of the Internal Audit Function by External Auditors

Upon reading the ED, it appears that the Board's focus on the subject of direct assistance has resulted in the standard discussing direct assistance to some length, but providing insufficient coverage of other potential uses of the internal audit function. In practice, we understand that external auditors could be making use of the internal audit function in various ways in risk assessment procedures and/or in gathering audit evidence in conducting the audit. As such, we believe that the proposed revisions to ISAs 315 and 610 should provide a more comprehensive coverage regarding the difference between using the work of an internal audit function for risk assessment and to provide background information to inform the design of external audit procedures, versus using internal audit information and work as a partial replacement for external audit procedures performed by the external auditor. The following are examples of various ways in which it appears that the work or information of a company's internal audit function could potentially be used:

1. The external auditor makes use of the internal audit function through making inquiries of the chief audit executive or other head of a company's internal audit function, as well as making inquiries of other managers and employees within the internal audit function;
2. The external auditor reads reports of work that internal auditors have performed while carrying out their internal audit functions during the period, or reviews other internal audit documents as a means to inform the external auditor's work;
3. If regulatory requirements permit, the external auditor, after appropriate review, decides to use reports or other work that has been performed by internal audit during the period in partial substitution for audit evidence to be gathered directly by the external auditor; and/or
4. If regulatory requirements permit, the external auditor uses staff members of the internal audit function to perform certain audit procedures under the direct supervision of the external auditor, i.e., in what is termed "a direct assistance capacity" as described in the ISA.

We noted that the phrase “using the work of internal audit” (or variations thereof) is used throughout the ED, without making it clear when the intent is to refer not only to direct assistance but also to one or more of the other uses of the internal audit function described above. We request that the Board be more specific as to which type of use it is referring to when using the term “using the work of internal audit” as the various types of use may each carry a different level of risk with respect to the external audit and warrant separate requirements and guidance. We believe that an ISA on use of internal audit should provide specific coverage on provisions and safeguards for each type of use.

The Explanatory Memorandum within the ED outlines rationale for and the benefits to be derived from the changes in these two ISAs, as well as their perceived effects; however, coverage in an Explanatory Memorandum may be lost when the ISAs are finalized. We believe that the ISA 315 and 610 standards themselves should say more about why external auditors might or might not wish to use the work of the internal audit function (in its various forms of use) including both the risks and benefits of using such work. That language should be included in the body of the standard to support clear and understandable requirements for making appropriate judgments regarding the use of internal audit functions.

Reperformance

Paragraph A20 of ISA 610 states 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. 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.”

We believe that this paragraph is too vague and soft with respect to reperformance needed when using the work of internal auditors in a “direct assistance” role or in any other capacity. This paragraph does not provide sufficient guidance for when reperformance should be performed. This could result in inadequate quality control and supervision. Further, we are concerned that making no mention of the risk of material misstatement in discussing areas where an external auditor might focus reperformance work could leave the reader with the impression that this risk is not an important factor.

We believe that the guidance in the ISA should be strengthened to ensure that the external auditor tests the internal auditor’s work both at the financial statement level and at the assertion level for all classes of transactions, account balances and disclosures if such internal audit work is used by the external auditor in a direct or “indirect assistance” capacity. To accomplish this, it may be necessary to address this subject in the Requirements section as well as in the Application Material section.

Direct Assistance

Paragraph 8 of ISA 610 states “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.” In light of this, we believe it would be prudent for the Board to make explicit mention within ISA 610 paragraph 8 of the independence concerns that drive such restrictions, including both the threat of the internal audit function auditing its own work, and the fact that internal auditors are employees of the audited entity.

We are aware that there are some jurisdictions that have national standards on auditing that contain specific procedures on direct assistance. We would encourage the Board, when finalizing ISA 610, to consider whether these national standards contain any additional conditions, safeguards, or guidance that would further strengthen the final version of the standard.

As a further comment relating to use of internal audit staff in a direct assistance capacity where permitted, our members believe that such use of the internal audit staff should be limited to areas of lower risk and/or lesser necessity for judgment, and limited control testing procedures that support the external auditor’s assessment of internal controls when doing risk assessment.

Paragraph 22 (c) of ISA 610 implies that when obtaining direct assistance one of the factors to be considered in determining the work that may be assigned to individual internal auditors is the amount of judgment involved in planning and performing relevant audit procedures. With only “judgment” mentioned in this paragraph, we are concerned that external audit procedures relating to areas of more than lower risk could be assigned to internal auditors if they are not deemed to involve making significant judgments. We believe that the risk of material misstatement should be included as a factor in this paragraph.

Paragraph 24 of ISA 610 states that “the level of supervision and review shall recognize that internal auditors are not independent of the entity.” We believe it should be explicitly stated in this requirement that significant supervision is needed in view of the fact that internal auditors are employees of the audited entity, and that the supervision should include some reperformance of the internal auditor’s work.

External Auditor’s Consideration of Risk Factors

Paragraph 15 of ISA 610 states that “in determining the planned use of the work of the internal audit function, the external auditor shall consider: ... (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.”

We believe the use of both significant judgment and a significant level of risk should be incorporated into the requirements throughout the body of the standards as appropriate since there may be audit areas in which the level of risk should be considered without regard to the amount of judgment involved. In particular paragraph 15 of ISA 610 should be expanded to include a bullet point “(d)” that could then address the risks that are judged to exist in the areas where use of internal audit work is contemplated, and provide that the external auditor’s involvement should be greater in areas that have more than minimal risk. Further, the lead sentence of paragraph 15 of ISA 610 which states that “in determining the planned use of the work of the internal audit function, the external auditor shall consider...” would be clearer and more specific if it says “the auditor shall determine the planned use of the work of the internal audit function and shall thereto determine...”

We also believe that both paragraph A6b of ISA 315 and the application material of ISA 610 should contain a specific requirement for the external auditor to follow up on negative information or concerns that are communicated to the audit engagement team by internal auditors, which may be indicative of a heightened risk of a material misstatement of the financial statements or a material change in the external auditor’s risk assessment, regardless of whether or not the external auditor initiated the inquiry. In addition, the external auditor should take a more proactive approach in seeking and understanding any such findings or concerns that the internal audit function may be privy to. We realize that ISAs do not have this specific provision for negative information or concerns that are communicated by non-internal audit employees. However, we think the same principle should apply to information presented by other individuals within the company outside of the internal audit function and the principle should be evaluated with respect to other ISAs.

Paragraph A6c of ISA 315 defines appropriate individuals within the internal audit function as “those who have the appropriate knowledge, experience, and authority, such as the chief internal audit executive.” We think this is too narrow a designation and the title used may not be universally recognized. Inquiries can and should be made of others within an internal audit function in both planning and conducting the audit, as numerous internal audit individuals may have relevant information that would assist the external auditor in identifying and addressing risks of material misstatement. As such, we recommend the sentence be expanded to include “those who have the appropriate knowledge, experience, and authority, such as the chief internal audit executive or other head of internal audit and other managers and employees within the internal audit staff.”

Gap With Respect to Decisions on Whether or Not to Use the Internal Audit Function

Paragraph 2 of ISA 610 states that “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” and further states that “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.” These statements

appear to leave a gap in having coverage in ISAs regarding the external auditor's determination of whether to use the work of the internal audit function. Although paragraph 13 later in ISA 610 provides some brief coverage, the sequence of this paragraph in relation to paragraph 2 in ISA 610 and the manner in which ISA 610 is titled and prefaced makes the content of paragraph 13 inconsequential. In addition, the proposed change to paragraph 23 of ISA 315 does not include any requirement or guidance on determining whether or not to use the internal audit function. In order to provide necessary coverage for this decision, paragraph 13 of ISA 610 should be brought forward and incorporated into paragraph 2 of ISA 610. Further, we recommend ISA 315 include language regarding determination requirements consistent with extant ISA 315 paragraph 23 to address the gap in ISA coverage of important and relevant judgment and decision making.

Language Used In the Standard

We believe that paragraphs 14 and 21 of ISA 610 should be expressed more directly and in the positive form rather than the negative. For example, paragraphs 14 [and 21] of ISA 610 which states that "the external auditor shall not use an internal audit function [shall not obtain the direct assistance of an internal auditor] where there is either a low degree of objectivity or a low degree of competence" can be revised to read "the external auditor shall only use the work of the internal audit function to substitute for the work of the external audit engagement team [shall only obtain direct assistance] if the internal audit function has both a high degree of objectivity and a high level of competence."

Definition of Internal Audit and Interaction between Internal Auditors and External Auditors

Prior to paragraph A2 of ISA 610, there is a heading "Relationship between the Internal Auditors and the External Auditor." However, it is only the activities of the internal audit function that are currently mentioned. We believe that this section should be enhanced by including the role and responsibilities of both the internal auditor and the external auditor and how they should interact.

Paragraph A2 of ISA 610 defines "Internal Auditing" as 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. We believe the definition should be expanded to include the role of internal audit with respect to effectiveness of the financial reporting process, as this is not an uncommon role for the internal audit function.

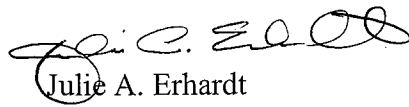
Paragraphs A8-A9 of ISA 610 provides examples of a "systematic and disciplined" approach. However, as the term "systematic and disciplined" is not defined or discussed in the Requirements section of the standard it is unclear what criteria would apply. We suggest that further discussion and/or some examples of approaches or criteria for approaches that would encompass what is intended by the term be provided particularly as 1) the Explanatory Memorandum states "the IAASB believes recognition of the fact

that the internal audit function applies a systematic and disciplined approach is important” and 2) the term is used throughout the ED.

In addition to the general comments we have made in the preceding text, Appendix A contains our responses to specific questions included in the ED.

Thank you for the opportunity to comment on this ED. If you have any questions or need additional information regarding this comment letter, you may contact me or Nigel James at 202-551-5300.

Sincerely,



Julie A. Erhardt
Chair

IOSCO Standing Committee No. 1

Appendix A:

Responses to Specific Questions in the Exposure Draft

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?

Please refer to our comments made under the headings “External Auditor’s Consideration of Risk Factors” and “Preserving the Principles of an External Audit.”

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?

We believe there is a gap in needed coverage in these ISAs. Please refer to our comments under the headings “Preserving the Principle of an Independent Audit”, “External Auditor’s Consideration of Risk Factors” and “Gap With Respect to Decisions on Whether or Not to Use the Internal Audit Function” in the body of our letter.

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?

This question seems to place an undue focus or emphasis on external auditors only reading the reports of internal auditors when the external auditor has made a decision to use the work of the internal audit function in one or more specific areas. We believe the external auditor should be encouraged to read reports of internal auditors when making risk assessment judgments and to follow up on other information that may be indicative of a material misstatement volunteered by internal auditors as part of the external auditor’s risk assessment, regardless of whether the external auditor intends to use the work of the internal audit function in particular areas.

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?

Please refer to our comments made under the headings “Direct Assistance” and “Various Uses of the Internal Audit Function by External Auditors” in the body of our letter.

5. Public Interest Concerns - Respondents are asked to address whether there are any public interest concerns that have not been addressed.

We believe there is a distinction between the roles of external auditors and internal auditors that is important to preserve, and that the concept of an "independent external audit" means that the audit must be the product of that external auditor's work. As such, external auditors must themselves perform sufficient procedures in gathering and corroborating audit evidence to reflect the external auditor's full responsibility for the audit opinion. External auditors should not rely on internal auditors with respect to the performance of significant substantive procedures or utilize internal audit evidence as the sole evidence in any area of the audit. Please refer to our comments under the heading “Preserving the Principle of an Independent External Audit.”

We also believe that it is important that each potential use of the internal audit function by external auditors be clearly articulated or adequately explained in the ED as mentioned under the heading “Various Uses of the Internal Audit Function by External Auditors” in the body of our letter.

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.

We have no comment to provide in this area.

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.

We have no comment to provide in this area.

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.

We have no comment to provide in this area.

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.

The use of the word “consider” throughout the ED can be difficult to translate in certain languages.

In addition, translation is more challenging where long sentences are used. As such, the use of short sentences should be used where practical.

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.

The provisional effective date seems reasonable, though the date for the Approval of Final Revised Standard may be an aggressive timeframe considering the potential for varying views.

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?

The Explanatory Memorandum provides useful background information to accompany the ISAs. However, we suggest that the Explanatory Memorandum, including the impact analysis, be expanded to address the effect of the ISAs on additional stakeholders such as audit committees, investors, issuers and regulators as it currently only addresses the impact on external auditors, internal audit functions/internal auditors and audit oversight bodies.

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?

See comments in 11 above.

13. Are there any changes to the narrative or tabular presentation of the impact analysis that would be helpful to respondents?

We have no comment to provide in this area.

14. Would respondents find such an approach useful at the national level?

We have no comment to provide in this area.