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# EXPOSURE DRAFT

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## PROPOSED STATEMENT ON AUDITING STANDARDS

### *USING THE WORK OF INTERNAL AUDITORS*

*(Supersedes Statement on Auditing Standards [SAS] No. 65, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements [AICPA, Professional Standards, AU sec. 322 and AU-C sec. 610]; Amends:*

- *SAS No. 122, Statements on Auditing Standards: Clarification and Recodification, section 315, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement [AICPA, Professional Standards, AU-C sec. 315]*
- *Various other sections in SAS No. 122 [AICPA, Professional Standards, AU-C secs. 200, 220, 230, 240, 260, 265, 300, 402, 500, 550, and 600];*
- *Statement on Quality Control Standards No. 8, A Firm's System of Quality Control [Redrafted] [AICPA, Professional Standards, QC sec. 10]).*

**April 15, 2013**

**Comments are requested by July 15, 2013**

**Prepared by the AICPA Auditing Standards Board for comment from persons  
interested in auditing and reporting issues.**

**Comments should be addressed to  
Sherry Hazel at [shazel@aicpa.org](mailto:shazel@aicpa.org). Comments are requested by July 15, 2013.**

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## EXPLANATORY MEMORANDUM

### Introduction

This memorandum provides background to proposed Statement on Auditing Standards (SAS), *Using the Work of Internal Auditors*. This proposed SAS would supersede SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, AU sec. 322 and AU-C sec. 610, *Using the Work of Internal Auditors*). The accompanying proposed SAS represents the redrafting of SAS No. 65 to apply the Auditing Standards Board's (ASB's) clarity drafting conventions and to converge with International Standards on Auditing (ISAs), as discussed in the following sections.<sup>1</sup>

### Background

#### Clarity

To address concerns over the clarity, length, and complexity of its standards, the ASB has undertaken a significant effort to clarify the SASs. The ASB issued a discussion paper titled *Improving the Clarity of ASB Standards*<sup>2</sup> in March 2007. In response to the feedback received on the discussion paper and subsequent discussions with interested parties, the ASB has established clarity drafting conventions and has undertaken to revise all of its SASs in accordance with those conventions. The proposed SAS has been drafted in accordance with the ASB's clarity drafting conventions, which include the following:

- Establishing objectives for each of the standards
- Including a definitions section, where relevant, in each standard
- Separating requirements from application and other explanatory material
- Numbering application and other explanatory material paragraphs using an A-prefix and presenting them in a separate section that follows the requirements section
- Using formatting techniques, such as bullet lists, to enhance readability
- Including, where appropriate, special considerations relevant to audits of smaller, less complex entities within the text of the standard
- Including, where appropriate, special considerations relevant to audits of governmental entities within the text of the standard

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<sup>1</sup> The *Clarity Project Explanatory Memorandum* provides a more detailed discussion of the Auditing Standards Board's (ASB) Clarity Project.

<sup>2</sup> The discussion paper is available online at [www.aicpa.org/InterestAreas/FRC/AuditAttest/Pages/ClarityProjectArchiveInformation.aspx](http://www.aicpa.org/InterestAreas/FRC/AuditAttest/Pages/ClarityProjectArchiveInformation.aspx).

## **Convergence**

In December 2011, the International Auditing and Assurance Standards Board (IAASB) finalized the wording of ISA 610 (Revised), *Using the Work of Internal Auditors* (ISA 610), including the provisions addressing direct assistance. However, the IAASB released only the section of the standard addressing the external auditor's use of the work of the internal audit function in March 2012 and did not release the section dealing with direct assistance. The delay in releasing the section on direct assistance was to allow the International Ethics Standards Board for Accountants (IESBA) the time it needed in 2012 to expose amendments to the definition of engagement team in the IESBA's *Code of Ethics for Professional Accountants* (IESBA Code).

The IAASB and IESBA worked closely on issues raised by respondents to the IESBA's February 2012 ED *Proposed Changes to the Definition of "Engagement Team."* The IESBA's proposal to exclude internal auditors providing direct assistance from the definition of the engagement team in the IESBA Code was contingent on being satisfied with the adequacy of the safeguards reflected in the requirements in ISA 610 (Revised) relating to using internal auditors in a direct assistance capacity. As a result, certain comments received on the IESBA ED were relevant to the provisions of ISA 610 (Revised) that addressed use of internal auditors in a direct assistance capacity.

In January 2013, the IESBA approved final amendments to the IESBA Code's definition of engagement team, and in February 2013, the IAASB approved the final provisions of ISA 610 (ISA 610 [Revised 2013]) addressing direct assistance, as well as necessary conforming amendments, to the definition of engagement team in the ISAs and International Standard on Quality Control (ISQC) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*, for purposes of alignment with the IESBA Code and conforming amendments to other ISAs.

The proposed SAS has been drafted using ISA 610 (Revised 2013) (including the section dealing with direct assistance) as a base. Differences in objectives, definitions, or requirements between the proposed SAS and ISA 610 (Revised 2013) are identified in the exhibit to the proposed SAS.

The ASB has made various changes to the language of the ISA to use terms or phrases that are more commonly used in the United States and to tailor examples and guidance to be more appropriate to the U.S. environment. The ASB believes that such changes will not create differences between the application of ISA 610 (Revised 2013) and the application of the proposed SAS, except for the section dealing with direct assistance wherein the ASB made changes to the ISA requirements in order to conform those requirements to our existing practice (see exhibit).

## **Effective Date**

The proposed SAS will be effective for audits of financial statements for periods ending on or after December 15, 2014.

## **Changes From Existing Standards**

### **Application of Systematic and Disciplined Approach**

Consistent with ISA 610 (Revised 2013), the proposed SAS introduces the concept of a *systematic and disciplined approach*, which is not included in extant AU-C section 610. Paragraph 14 of the proposed SAS would require, among other things, as a prerequisite to being able to use the work of the internal audit function, that the external auditor evaluate the application by the internal audit function of a *systematic and disciplined approach, including quality control*. Paragraphs A10–A12 of the proposed SAS provide application guidance in regards to the application of a systematic and disciplined approach. The ASB believes that relative to our extant standards, this requirement represents an additional and explicit evaluation which the external auditor would need to perform to conclude on the appropriateness of using the work of internal auditors.

### **Issue for Consideration**

Using the work of internal auditors—including using internal auditors in a direct assistance capacity—represents longstanding current practice in the United States. Using the work of internal auditors to assist the external auditor in an audit does not appear to have resulted in practice issues or situations where it can be demonstrated that use of internal auditors, and specifically use in a direct assistance capacity, has detracted from overall audit quality. The ASB is not aware of any significant audit failures that can be attributed to external auditors having used internal auditors in a direct assistance capacity.

In order to align the proposed SAS to our existing practice, the ASB is proposing changes to the requirements and application guidance in ISA 610 (Revised 2013) related to using internal auditors in a direct assistance capacity. The proposed changes are described more fully in the exhibit of the proposed SAS. The ASB is specifically seeking respondents' views on the proposed requirements and application guidance relating to using internal auditors in a direct assistance capacity and whether the changes from the requirements and guidance included in ISA 610 (Revised 2013) are appropriate.

### **Guide for Respondents**

The ASB is seeking comments specifically on changes resulting from applying the clarity drafting conventions and converging with the ISA, and their effect on the content of the proposed SAS. Respondents are asked to respond, in particular, to the following questions:

1. Are the objectives to be achieved by the auditor, stated in the proposed SAS, appropriate?
2. Are revisions from the existing standards to converge with ISA 610 (Revised 2013) appropriate?
3. Are the differences between the proposed SAS and ISA 610 (Revised 2013) identified in the exhibit, and other language changes, appropriate?

4. Have considerations for audits of smaller, less complex entities and governmental entities been dealt with appropriately?

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 the exposure draft, it will be helpful for the ASB to be made aware of this view.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the offices of the AICPA after July 31, 2013, for one year. Responses should be sent to Sherry Hazel, Audit and Attest Standards, AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775 in time to be received by July 15, 2013. Responses may also be sent by e-mail to [shazel@aicpa.org](mailto:shazel@aicpa.org).

### **Supplements to the Exposure Draft**

To assist respondents in identifying changes and in responding to this request to comment on the proposed SAS, the Audit and Attest Standards staff has prepared supplementary material that compares ISA 610 (Revised 2013), the proposed SAS, and AU-C section 610. The schedule has four columns containing the following:

1. ISA 610 (Revised 2013).
2. The proposed SAS, marked to show differences in language between the ISA and the proposed SAS. New material is shown in boldface italics; deleted material is shown in strikethrough.
3. The requirements and guidance in extant AU-C section 610, mapped against the proposed SAS to demonstrate how the material in AU-C section 610 has been reflected in the proposed SAS.
4. Comments.

This staff-prepared supplementary material is available on the AICPA website at [www.aicpa.org/Research/ExposureDrafts/AccountingandAuditing/Pages/ExposureDrafts\\_ASB.aspx](http://www.aicpa.org/Research/ExposureDrafts/AccountingandAuditing/Pages/ExposureDrafts_ASB.aspx). It is for information purposes only and does not form part of the exposure draft; however, it may be useful for respondents in formulating comments.

### **Comment Period**

The comment period for this exposure draft ends on July 15, 2013.



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**PROPOSED STATEMENT ON AUDITING STANDARDS  
USING THE WORK OF INTERNAL AUDITORS**

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# **Proposed Statement on Auditing Standards *Using the Work of Internal Auditors***

## ***Introduction***

### **Scope of This Proposed Statement on Auditing Standards**

1. This proposed Statement on Auditing Standards (SAS) addresses the external auditor's responsibilities if using the work of internal auditors. This includes (a) using the work of the internal audit function in obtaining audit evidence and (b) using internal auditors to provide direct assistance under the direction, supervision, and review of the external auditor.
2. This proposed SAS does not apply if the entity does not have an internal audit function. (Ref: par. A2)
3. If the entity has an internal audit function, the requirements in this proposed SAS relating to using the work of that function do not apply if
  - a. the responsibilities and activities of the function are not relevant to the audit or
  - b. based on the auditor's preliminary understanding of the function obtained as a result of procedures performed under AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, the external auditor does not expect to use the work of the function in obtaining audit evidence.

Nothing in this proposed SAS requires the external auditor 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 directly by the external auditor; it remains the external auditor's decision to establish the overall audit strategy.

4. Furthermore, the requirements in this proposed SAS relating to direct assistance do not apply if the external auditor does not plan to use internal auditors to provide direct assistance.

### **Relationship Between AU-C Section 315 and Proposed AU-C Section 610**

5. Many entities establish internal audit functions as part of their internal control and governance structures. The objectives and scope of an internal audit function, the nature of its responsibilities, and its organizational status, including the function's authority and accountability, vary widely and depend on the size and structure of the entity and the requirements of management and, when applicable, those charged with governance.

6. AU-C section 315 addresses how the knowledge and experience of the internal audit function can inform the external auditor's understanding of the entity and its environment, and identification and assessment of risks of material misstatement. AU-C section 315<sup>3</sup> also explains how effective communication between the internal and external auditors creates an environment in which the external auditor can be informed of significant matters that may affect the external auditor's work.

7. The external auditor may be able to use the work of the internal audit function in a constructive and complementary manner dependent on the level of competency of the internal audit function, whether the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, and whether the function applies a systematic and disciplined approach. This proposed SAS addresses the external auditor's responsibilities when, based on the external auditor's understanding of the internal audit function obtained as a result of procedures performed under AU-C section 315, the external auditor expects to use the work of the internal audit function as part of the audit evidence obtained.<sup>4</sup> Such use of that work modifies the nature or timing, or reduces the extent, of audit procedures to be performed directly by the external auditor.

8. This proposed SAS addresses the external auditor's responsibilities if the external auditor is considering using internal auditors to provide direct assistance under the direction, supervision, and review of the external auditor.<sup>5</sup>

9. There may be individuals in an entity that perform 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 AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.

### **The External Auditor's Responsibility for the Audit**

10. 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 or internal auditors to provide direct assistance on the engagement. Although the function may perform audit procedures similar to those performed by the external auditor, 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 paragraph .15 of AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally*

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<sup>3</sup> Paragraph .A116 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

<sup>4</sup> See paragraphs 14–25 of this proposed Statement on Auditing Standards (SAS).

<sup>5</sup> See paragraphs 26–31 of this proposed SAS.

*Accepted Auditing Standards.* This proposed SAS, therefore, defines the conditions that are necessary for the external auditor to be able to use the work of internal auditors. It also defines the necessary work effort to obtain sufficient appropriate evidence that the work of the internal audit function or internal auditors providing direct assistance is adequate for the purposes of the audit. The requirements are designed to provide a framework for the external auditor's judgments regarding the use of the work of internal auditors to prevent over or undue use of such work.

### **Effective Date**

**11.** This SAS is effective for audits of financial statements for periods ending on or after December 15, 2014.

### ***Objectives***

**12.** When the entity has an internal audit function and the external auditor expects to use the work of internal auditors to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor, the objectives of the external auditor are as follows:

- a.* To determine whether the work of the internal audit function or direct assistance from internal auditors can be used, and if so, in which areas and to what extent

and having made that determination:

- b.* If using the work of the internal audit function, to determine whether that work is adequate for purposes of the audit
- c.* If using internal auditors to provide direct assistance, to appropriately direct, supervise, and review their work

### ***Definitions***

**13.** For purposes of generally accepted auditing standards (GAAS), the following terms have the meaning attributed as follows:

**Direct assistance.** The use of internal auditors to perform audit procedures under the direction, supervision, and review of the external auditor.

**Internal audit function.** A function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management, and internal control processes. (Ref: par. A1–A4)

## ***Requirements***

### **Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used**

#### ***EVALUATING THE INTERNAL AUDIT FUNCTION***

**14.** The external auditor should 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: par. A5–A9)
- b.* The level of competence of the internal audit function (Ref: par. A5–A9)
- c.* The application by the internal audit function of a systematic and disciplined approach, including quality control (Ref: par. A10–A12)

**15.** The external auditor should not use the work of the internal audit function if the external auditor determines that

- a.* the function's organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors;
- b.* the function lacks sufficient competence; or
- c.* the function does not apply a systematic and disciplined approach, including quality control. (Ref: par. A13–A15)

#### ***DETERMINING THE NATURE AND EXTENT OF WORK OF THE INTERNAL AUDIT FUNCTION THAT CAN BE USED***

**16.** The external auditor should make all significant judgments in the audit engagement. (Ref: par. A16)

**17.** As a basis for determining the areas and the extent to which the work of the internal audit function can be used, the external auditor should consider the nature and scope of the work that has been performed, or is planned to be performed, by the internal audit function and its relevance to the external auditor's overall audit strategy and audit plan. (Ref: par. A17–A20)

**18.** To prevent undue use of the internal audit function, the external auditor should plan to use less of the work of the function and perform more of the work directly (Ref: par. A17–A20) for the following circumstances:

- a.* When more judgment is involved in
  - i.* planning and performing relevant audit procedures and
  - ii.* evaluating the audit evidence gathered. (Ref: par. A21)
- b.* The higher the assessed risk of material misstatement at the assertion level, with special consideration given to significant risks (Ref: par. A22–A24)

- c. The less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors
  - d. The lower the level of competence of the internal audit function
- 19. The external auditor should also evaluate whether, in aggregate, using the work of the internal audit function to the extent planned would still result in the external auditor being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed. (Ref: par. A16–A24)

### **Communication With Those Charged With Governance**

20. In communicating an overview of the planned scope and timing of the audit to those charged with governance in accordance with paragraph .11 of AU-C section 260, *The Auditor's Communication With Those Charged With Governance*, the external auditor should communicate how the external auditor has planned to use the work of the internal audit function. (Ref: par. A25)

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

21. If the external auditor plans to use the work of the internal audit function, the external auditor should discuss the planned use of its work with the function as a basis for coordinating their respective activities. (Ref: par. A26–A29)
22. The external auditor should read the reports of the internal audit function which relate to the work of the function that the external auditor plans to use to obtain an understanding of the nature and extent of audit procedures the internal audit function performed and the related findings.
23. The external auditor should perform sufficient audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use to determine its adequacy for purposes of the audit, including evaluating whether
- a. the work of the function was properly planned, performed, supervised, reviewed, and documented;
  - b. sufficient appropriate evidence was obtained to enable the function to draw reasonable conclusions; and
  - c. conclusions reached are appropriate in the circumstances and the reports prepared by the function are consistent with the results of the work performed. (Ref: par. A30–A33)
24. The nature and extent of the external auditor's audit procedures should be responsive to the external auditor's evaluation of
- a. the amount of judgment involved;
  - b. the assessed risk of material misstatement;
  - c. the extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors; and



- d. the level of competence of the function.<sup>6</sup> (Ref: par. A30–A32)

The external auditor should also include reperformance of some of the work. (Ref: par. A33)

**25.** The external auditor should evaluate whether the external auditor’s conclusions regarding the internal audit function in paragraph 14 and the determination of the nature and extent of use of the work of the function for purposes of the audit in paragraphs 18–19 remain appropriate.

**Determining Whether, in Which Areas, and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance**

***DETERMINING WHETHER INTERNAL AUDITORS CAN BE USED TO PROVIDE DIRECT ASSISTANCE FOR PURPOSES OF THE AUDIT***

**26.** If the external auditor plans to use internal auditors to provide direct assistance on the audit, the external auditor should evaluate the existence and significance of threats to objectivity, as well as any safeguards that have been put in place, to mitigate such threats, and the level of competence of the internal auditors who will be providing such assistance. (Ref: par. A34–A37)

**27.** The external auditor should not use an internal auditor to provide direct assistance if

- a. significant threats to the objectivity of the internal auditor exist and the internal auditor lacks the necessary objectivity to perform the proposed work or
- b. the internal auditor lacks the necessary competence to perform the proposed work. (Ref: par. A34–A37)

***DETERMINING THE NATURE AND EXTENT OF WORK THAT CAN BE ASSIGNED TO INTERNAL AUDITORS PROVIDING DIRECT ASSISTANCE***

**28.** In determining the nature and extent of work that may be assigned to internal auditors providing direct assistance and the nature, timing, and extent of direction, supervision, and review that is appropriate in the circumstances, the external auditor should consider

- a. the external auditor’s evaluation of the existence and significance of threats to the objectivity and level of competence of the internal auditors who will be providing such assistance;
- b. the assessed risk of material misstatement; and
- c. the amount of judgment involved in
  - i. planning and performing relevant audit procedures and

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<sup>6</sup> See paragraph 14 of this proposed SAS.

- ii. evaluating the audit evidence gathered. (Ref: par. A38–A39)

### **Using Internal Auditors to Provide Direct Assistance**

**29.** In communicating an overview of the planned scope and timing of the audit to those charged with governance in accordance with paragraph .11 of AU-C section 260, the external auditor should communicate how the external auditor plans to use internal auditors to provide direct assistance.

**30.** The external auditor should direct, supervise, and review the work performed by internal auditors on the engagement in accordance with AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*. In so doing

- a. the nature, timing, and extent of direction, supervision, and review should be responsive to the outcome of the evaluation of the factors in paragraph 28 of this proposed SAS;
- b. the external auditor should instruct the internal auditors to bring accounting and auditing issues identified during the audit to the attention of the external auditor; and
- c. the review procedures should include the external auditor testing some of the work performed by the internal auditors. (Ref: par. A40–A41)

**31.** In directing, supervising, and reviewing the work performed by internal auditors, the external auditor should remain alert for indications that the external auditor's evaluations in paragraph 26 are no longer appropriate.

### **Documentation**

**32.** If the external auditor uses the work of the internal audit function, the external auditor should include the following in the audit documentation:

- a. The results of the evaluation of
  - i. the function's organizational status and relevant policies and procedures to adequately support the objectivity of the internal auditors;
  - ii. the level of competence of the function; and
  - iii. the application by the function of a systematic and disciplined approach, including quality control.
- b. The nature and extent of the work used (including the period covered by such work) and the basis for that decision
- c. The audit procedures performed by the external auditor to evaluate the adequacy of the work used

**33.** If the external auditor uses internal auditors to provide direct assistance on the audit, the external auditor should include the following in the audit documentation:

- a. The evaluation of the existence and significance of threats to the objectivity of the internal auditors, as well as any safeguards that have been put in place to

mitigate such threats, and the level of competence of the internal auditors used to provide direct assistance

- b. The basis for the decision regarding the nature and extent of the work performed by the internal auditors
- c. The nature and extent of the external auditor's review of the audit work in accordance with AU-C section 230, *Audit Documentation*
- d. The working papers prepared by the internal auditors who provided direct assistance on the audit engagement

## ***Application and Other Explanatory Material***

### **Definition of Internal Audit Function (Ref: par. 2 and 13)**

**A1.** The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve the effectiveness of the entity's governance, risk management, and internal control processes such as the following:

#### *Activities Relating to Governance Process*

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

#### *Activities Relating to Risk Management Process*

- The internal audit function may assist the entity by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and internal control (including effectiveness of the financial reporting process).
- The internal audit function may perform procedures to assist the entity in the detection of fraud.

#### *Activities Relating to Internal Control Process*

- *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 control. 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 control, including those that are relevant to the audit.
- *Examination of financial and operating information.* The internal audit function may be assigned to review the means used to identify, recognize,

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 nonfinancial 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.

**A2.** 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 sole determinants of whether or not the external auditor can use the work of internal auditors. Rather it is the nature of the activities, the extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors, competence, and systematic and disciplined approach of the function that are relevant. References in this proposed SAS to the work of the internal audit function include relevant activities of other functions or third party providers that have these characteristics.

**A3.** However, those in the entity with operational and managerial duties and responsibilities outside of the internal audit function would ordinarily face threats to their objectivity that would preclude them from being treated as part of an internal audit function for the purpose of this proposed SAS, although they may perform control activities that can be tested in accordance with paragraph .09 of AU-C section 330. For this reason, monitoring controls performed by an owner-manager would not be considered equivalent to an internal audit function.

**A4.** Although the objectives of an entity's internal audit function and the external auditor differ, the function may perform audit procedures similar to those performed by the external auditor in an audit of financial statements. If so, the external auditor may make use of the function for purposes of the audit in one or more of the following ways:

- To obtain information that is relevant to the external auditor's assessments of the risks of material misstatement due to error or fraud. In this regard, paragraph .06(a) of AU-C section 315 requires the external auditor to obtain an understanding of the nature of the internal audit function's responsibilities, its status within the organization, and the activities performed, or to be performed, and make inquiries of appropriate individuals within the internal audit function (if the entity has such a function).
- The external auditor, after appropriate evaluation, may decide to use work that has been performed by the internal audit function during the period being audited to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the external auditor; that is, the

external auditor can use the work of the internal audit function in partial substitution for audit evidence to be obtained directly by the external auditor (see paragraphs A16–A20).<sup>7</sup>

In addition, the external auditor may use internal auditors to perform audit procedures under the direction, supervision, and review of the external auditor (referred to as direct assistance in this proposed SAS).<sup>8</sup>

## **Determining Whether, in Which Areas, and to What Extent the Work of the Internal Audit Function Can Be Used**

### ***EVALUATING THE INTERNAL AUDIT FUNCTION***

#### ***Objectivity and Competence (Ref: par. 14[a]–[b])***

**A5.** 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 can be used in the circumstances.

**A6.** The extent to which the internal audit function’s organizational status and relevant policies and procedures support the objectivity of the internal auditors and the level of competence of the function are particularly important in determining whether to use the work of the internal audit function and, if so, the nature and extent of the use of the work of the function that is appropriate in the circumstances.

**A7.** Objectivity refers to the ability to perform tasks without allowing bias, conflict of interest, or undue influence of others to override professional judgments. Factors that may affect the external auditor’s evaluation of objectivity include the following:

- Whether the organizational status of the internal audit function, including the function’s authority and accountability, supports the ability of the function to be free from bias, conflict of interest, or undue influence of others to override professional judgments. For example, whether the internal audit function reports to those charged with governance or an officer with appropriate authority, or if the function reports to management, whether it has direct access to those charged with governance.
- Whether the internal audit function is free of any conflicting responsibilities (for example, having managerial or operational duties or responsibilities that are outside of the internal audit function).
- Whether those charged with governance oversee employment decisions related to the internal audit function (for example, determining the appropriate remuneration policy).

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<sup>7</sup> See paragraphs 14–25.

<sup>8</sup> See paragraphs 26–31.

- Whether any constraints or restrictions placed on the internal audit function by management or those charged with governance exist (for example, in communicating the internal audit function's findings to the external auditor).
- Whether the internal auditors are members of relevant professional bodies and their memberships obligate their compliance with relevant professional standards relating to objectivity or whether their internal policies achieve the same objectives.

**A8.** Competence of the internal audit function refers to the attainment and maintenance of knowledge and skills of the function as a whole at the level required to enable assigned tasks to be performed diligently and in accordance with applicable professional standards. Factors that may affect the external auditor's determination about competence include the following:

- Whether the internal audit function is adequately and appropriately resourced relative to the size of the entity and the nature of its operations.
- Whether established policies for hiring, training, and assigning internal auditors to internal audit engagements exist.
- Whether the internal auditors have adequate technical training and proficiency in auditing. Relevant criteria that may be considered by the external auditor in making the assessment may include, for example, the internal auditors' possession of a relevant professional designation and experience.
- Whether the internal auditors possess the required knowledge relating to the entity's financial reporting and the applicable financial reporting framework and whether the internal audit function possesses the necessary skills (for example, industry-specific knowledge) to perform work related to the entity's financial statements.
- Whether the internal auditors are members of relevant professional bodies that oblige them to comply with the relevant professional standards, including continuing professional development requirements.

**A9.** Objectivity and competence may be viewed as a continuum. The more the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, and the higher the level of competence of the function, the more likely the external auditor may make use of the work of the function and make use of it in more areas. However, an organizational status and relevant policies and procedures that provide strong support for the objectivity of the internal auditors cannot compensate for the lack of sufficient competence of the internal audit function. Equally, a high level of competence of the internal audit function cannot compensate for an organizational status and policies and procedures that do not adequately support the objectivity of the internal auditors.

*Application of a Systematic and Disciplined Approach (Ref: par. 14[c])*

**A10.** The application of a systematic and disciplined approach to planning, performing, supervising, reviewing, and documenting its activities distinguishes the activities of the

internal audit function from other monitoring control activities that may be performed within the entity.

**A11.** Factors that may affect the external auditor's determination of whether the internal audit function applies a systematic and disciplined approach include the following:

- The existence, adequacy, and use of documented internal audit procedures or guidance covering such areas as risk assessments, work programs, documentation, and reporting, as well as the nature and extent of which is commensurate with the nature and size of the internal audit function relative to the complexity of the entity.
- Whether the internal audit function has appropriate quality control policies and procedures (for example, those relating to leadership, human resources, and engagement performance or quality control requirements in standards set by relevant professional bodies for internal auditors). Such bodies may also establish other appropriate requirements such as conducting periodic external quality assessments.

**A12.** The auditor's determination of whether the internal audit function applies a systematic and disciplined approach is intended to address the risk that the auditor inappropriately uses internal audit-like work performed in an informal, unstructured, or ad hoc manner. However, the level of formality of an acceptable approach may vary depending on the nature and size of the internal audit function relative to the complexity of the entity.

*Circumstances When Work of the Internal Audit Function Cannot Be Used (Ref: par. 15)*

**A13.** The external auditor's evaluation of whether the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, the level of competence of the internal audit function, and whether it applies a systematic and disciplined approach may indicate that the risks to the quality of the work of the function are too significant and, therefore, not appropriate to use any of the work of the function as audit evidence.

**A14.** Consideration of the factors in paragraphs A7, A8, and A11 individually, and in aggregate, is important because an individual factor is often not sufficient to conclude that the work of the internal audit function cannot be used for purposes of the audit. For example, the internal audit function's organizational status is particularly important in evaluating threats to the objectivity of the internal auditors. If the internal audit function reports to management other than for budgetary purposes, this may impair the function's objectivity absent to sufficient safeguards (for example, having direct access and performance accountability to those charged with governance).

**A15.** In addition, a self-review threat is created when the external auditor accepts an engagement to provide internal audit services to an audit client and the results of those services will be used in conducting the audit. This is because of the possibility that the engagement team will use the results of the internal audit service without properly evaluating those results or without exercising the same level of professional skepticism as

would be exercised when the internal audit work is performed by individuals who are not members of the firm.

***DETERMINING THE NATURE AND EXTENT OF WORK OF THE INTERNAL AUDIT  
FUNCTION THAT CAN BE USED***

*Factors Affecting the Determination of the Nature and Extent of the Work of the Internal Audit Function That Can Be Used (Ref: par. 16–19)*

**A16.** Because 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 the following:

- Assessing the risks of material misstatement
- Evaluating the sufficiency of tests performed
- Evaluating the appropriateness of management’s use of the going concern assumption and whether there is substantial doubt about the entity’s ability to continue as a going concern for a reasonable period of time
- Evaluating significant accounting estimates
- Evaluating the adequacy of disclosures in the financial statements and other matters affecting the auditor’s report

**A17.** Once the external auditor has determined that the work of the internal audit function can be used for purposes of the audit, a first consideration is whether the planned nature and scope of the work of the internal audit function that has been performed, or is planned to be performed, is relevant to the overall audit strategy and audit plan that the external auditor has established in accordance with AU-C section 300, *Planning an Audit*.

**A18.** In accordance with AU-C section 330, the external auditor is required to design and perform further audit procedures whose nature, timing, and extent are based on, and responsive to, the assessed risks of material misstatement at the relevant assertion level.<sup>9</sup> Further audit procedures comprise tests of controls and substantive procedures. Procedures planned or performed by the internal audit function may be the same as, or be similar to, the further audit procedures that the external auditor would design and perform. Accordingly, subject to the requirements of this proposed SAS, the external auditor may determine that it is appropriate to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of further audit procedures to be performed directly by the external auditor. The internal audit function may have performed, or may be planning to perform

- tests of relevant controls upon which the external auditor intends to rely on in determining the nature, timing, and extent of substantive procedures. For

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<sup>9</sup> Paragraph .06 of AU-C section 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*.



example, the work of the internal audit function may include tests of relevant controls that address the risks of material misstatement related to the completeness of accounts payable. The results of internal audit functions' tests may provide sufficient appropriate audit evidence about the effectiveness of controls and, accordingly, the external auditor may be able to use such tests of controls performed by the internal audit function to reduce the nature and extent of testing of controls the external auditor would otherwise have performed directly.

- substantive procedures. For example, the internal audit function, as part of its work, may confirm certain accounts receivable and observe certain physical inventories. By using such work of the internal audit function, the external auditor may be able to change the timing of the confirmation procedures, the number of accounts receivable to be confirmed, or the number of locations of physical inventories to be observed.

The internal audit function's plan may also include procedures related to financial information of components of a group. The external auditor may coordinate work with the internal auditors (in accordance with paragraph 21) and reduce the number of the entity's components at which the external auditor would otherwise need to perform auditing procedures in accordance with the requirements of AU-C section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*.

**A19.** Other examples of work of the internal audit function that can be used by the external auditor include the following:

- Tracing transactions through the information system relevant to financial reporting
- Testing of compliance with regulatory requirements

**A20.** The external auditor's determination of the planned nature and extent of use of the work of the internal audit function will be influenced by the external auditor's evaluation of the extent to which the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors and the level of competence of the internal audit function in paragraph 14. In addition, the amount of judgment needed in planning, performing, and evaluating such work and the assessed risk of material misstatement at the assertion level are inputs to the external auditor's determination. Further, circumstances exist in which the external auditor cannot use the work of the internal audit function for purpose of the audit as described in paragraph 15.

*Judgments In Planning and Performing Audit Procedures and Evaluating Results (Ref: par. 18[a])*

**A21.** As the degree of judgment involved in planning and performing the audit procedures and evaluating the audit evidence increases, the need for the external auditor to perform more procedures directly in accordance with paragraph 18 increases.

*Assessed Risk of Material Misstatement (Ref: par. 18[b] and 30[a])*

**A22.** For a particular account balance, class of transaction, or disclosure, the higher an assessed risk of material misstatement at the assertion level, the more judgment is often involved in planning and performing the audit procedures and evaluating the results thereof. In such circumstances, the external auditor will need to perform more procedures directly in accordance with paragraph 18 and, accordingly, make less use of the work of the internal audit function in obtaining sufficient appropriate audit evidence. Furthermore, as explained in paragraph .A33 of AU-C section 200, 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 external auditor will need to perform more of the work directly.

**A23.** As explained in paragraph .04 of AU-C section 315, significant risks require special audit consideration, and therefore the external auditor's ability to use the work of the internal audit function in relation to significant risks will be restricted to procedures that involve limited judgment. In addition, when the risks of material misstatement is other than low, the use of the work of the internal audit function alone is unlikely to reduce audit risk to an acceptably low level and eliminate the need for the external auditor to perform some tests directly.

**A24.** Carrying out procedures in accordance with this proposed SAS may cause the external auditor to reevaluate the assessment of the risks of material misstatement. Consequently, this may affect the external auditor's determination of whether and how to use the work of the internal audit function.

**Communication With Those Charged With Governance (Ref: par. 20)**

**A25.** In accordance with paragraph .11 of AU-C section 260, the external auditor is required to communicate an overview of the planned scope and timing of the audit with those charged with governance. The planned use of the work of the internal audit function is an integral part of the external auditor's overall audit strategy and is therefore relevant to those charged with governance for their understanding of the proposed audit approach.

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

*Discussion and Coordination With the Internal Audit Function (Ref: par. 21)*

**A26.** In discussing the planned use of its 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 nature of the work performed
- 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 and sample sizes

- Documentation of the work performed
- Review and reporting procedures

**A27.** For example, 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 informs the internal audit function of significant matters that may affect the function.
- the external auditor is advised of and has access to relevant reports of the internal audit function and is informed of any significant matters that come to the attention of the function when such matters may affect the work of the external auditor so that the external auditor is able to consider the implications of such matters for the audit engagement.

Although the auditor is not precluded from using work that the internal audit function has already performed, coordination of activities between the external auditor and internal audit function is likely to be most effective when appropriate interaction occurs before the internal audit function performs the work.

**A28.** Paragraphs .17 and .A22 of AU-C section 200 discuss 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.

**A29.** Communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring matters that may affect the work of the external auditor to the external auditor's attention.<sup>10</sup> The external auditor is then able to take such information into account in the external auditor's identification and assessment of risks of material misstatement. In addition, if such information may be indicative of a heightened risk of a material misstatement of the financial statements or may be regarding any actual, suspected, or alleged fraud, the external auditor can take this into account in the external auditor's identification of risk of material misstatement due to fraud in accordance with AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*.<sup>11</sup>

*Procedures to Determine the Adequacy of the Work of the Internal Audit Function (Ref: par. 23–24)*

**A30.** The external auditor's audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use provide a basis for evaluating

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<sup>10</sup> Paragraph .A121 of AU-C section 315.

<sup>11</sup> Paragraph .A11 of AU-C section 315, in relation to AU-C section 240, *Consideration of Fraud in a Financial Statement Audit*.

the overall quality of the function's work and the objectivity with which it has been performed.

**A31.** The procedures the external auditor may perform to evaluate the quality of the work performed and the conclusions reached by the internal audit function, in addition to reperformance in accordance with paragraph 24, include the following:

- Making inquiries of appropriate individuals within the internal audit function
- Observing procedures performed by the internal audit function
- Reviewing the internal audit function's work program and working papers

**A32.** The more judgment involved, the higher the assessed risk of material misstatement. The less the internal audit function's organizational status and relevant policies and procedures adequately support the objectivity of the internal auditors, or the lower the level of competence of the internal audit function, the more audit procedures are needed to be performed by the external auditor on the overall body of work of the function to support the decision to use the work of the function in obtaining sufficient appropriate audit evidence on which to base the audit opinion.

#### ***REPERFORMANCE***

**A33.** For purposes of this proposed SAS, reperformance involves the external auditor's independent execution of procedures to validate the conclusions reached by the internal audit function. This objective may be accomplished by examining items already examined by the internal audit function, or sufficient other similar items not actually examined by the internal audit function. Reperformance provides more persuasive evidence regarding the adequacy of the work of the internal audit function compared to other procedures the external auditor may perform as described in paragraph A31. Although it is not necessary for the external auditor to do reperformance in each area of work of the internal audit function that is being used, some reperformance is required on the body of work of the internal audit function as a whole that the external auditor plans to use in accordance with paragraph 24. 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 and in areas of higher risk of material misstatement.

#### **Determining Whether, in Which Areas, and to What Extent Internal Auditors Can Be Used to Provide Direct Assistance**

##### ***DETERMINING WHETHER INTERNAL AUDITORS CAN BE USED TO PROVIDE DIRECT ASSISTANCE FOR PURPOSES OF THE AUDIT (REF: PAR. 26–27)***

**A34.** The external auditor may obtain direct assistance from the internal auditors to carry out audit procedures which otherwise would be performed directly by the external auditors themselves. In such circumstances, the internal auditors are under the direction, supervision, and review of the external auditor.

**A35.** In accordance with paragraph 26, the external auditor evaluates the existence and significance of any threats to the objectivity and the level of competence of the internal

auditors who are used to provide direct assistance on the audit before assigning them to specific tasks. Evaluating the existence and significance of threats to objectivity includes evaluating safeguards that have been put in place to mitigate such threats.

**A36.** As stated in paragraph A7, objectivity refers to the ability to perform the proposed work without allowing bias, conflict of interest, or undue influence of others to override professional judgments. In evaluating the existence and significance of any threats to the objectivity of an individual internal auditor, the external auditor may consider the extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors, including, for example, policies and procedures addressing association with the division or department in the entity to which the work relates. Additionally, other matters may come to the external auditor's attention that may be relevant to the external auditor's evaluation of the objectivity of the internal auditor.

**A37.** In evaluating the level of competence of an internal auditor, many of the factors in paragraph A8 may also be relevant, but in the context of individual internal auditors and the work to which they may be assigned.

***DETERMINING THE NATURE AND EXTENT OF WORK THAT CAN BE ASSIGNED TO INTERNAL AUDITORS PROVIDING DIRECT ASSISTANCE (REF: PAR. 28)***

**A38.** Paragraphs A16–A24 provide relevant guidance in determining the nature and extent of work that may be assigned to internal auditors. As the materiality of the financial statement amounts increases, and either the assessed risks of material misstatement or the amount of judgment involved increases, the need for the external auditor to perform procedures directly increases. As these factors decrease, the need for the external auditor to perform procedures directly decreases.

**A39.** In determining the nature of work that may be assigned to internal auditors, the external auditor is careful to limit such work to those areas that would be appropriate to be assigned. Examples of activities and tasks that would not be appropriate to use internal auditors to provide direct assistance include the following:

- Making required inquiries of entity personnel or those charged with governance related to the identification of fraud risks and determining the procedures to respond to such risks. However, the external auditors may make inquiries of internal auditors about fraud risks in the organization in accordance with paragraph .06(a) of AU-C section 315.
- Determination of unpredictable audit procedures as addressed in AU-C section 240.

**Using Internal Auditors to Provide Direct Assistance (Ref: par. 30)**

**A40.** The direction, supervision, and review by the external auditor of the audit procedures performed by the internal auditors need to be sufficient in order for the external auditor to be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions based on that work. 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 external auditor's involvement in these

circumstances may be of a different nature or may be more extensive than if members of the engagement team perform the work.

**A41.** The nature, timing, and extent of direction, supervision, and review of the audit procedures performed by the internal auditors is also dependent on the outcome of the external auditor's evaluation of the objectivity and the level of competence of, and the nature and extent of, audit procedures to be performed by the internal auditors. Directing and supervising the internal auditors involves informing them of their responsibilities, the objectives of the procedures they are to perform, and matters that may affect the nature, timing, and extent of audit procedures, such as possible accounting and auditing issues. In reviewing the work performed by the internal auditors, the external auditor's considerations include whether the evidence obtained is sufficient and appropriate in the circumstances and that it supports the conclusions reached.

A42.

**Appendix A—Proposed Amendments to SAS No. 122, Section 315,  
*Understanding the Entity and Its Environment and Assessing the Risks of  
Material Misstatement***

**Boldface italics** denotes new language. Deleted text is shown in ~~strikethrough~~.

[No amendments to paragraphs .01–.05.]

**.06** The risk assessment procedures should include the following:

- a. Inquiries of management, ***of appropriate individuals within the internal audit function (if the function exists)***, and others within the entity who, in the auditor’s professional judgment, may have information that is likely to assist in identifying risks of material misstatement due to fraud or error (Ref: par. .A6)
- b. Analytical procedures (Ref: par. .A7–.A10)
- c. Observation and inspection (Ref: par. .A11)

[No amendments to paragraphs .07–.23.]

**.24** If the entity has an internal audit function,<sup>3</sup> the auditor should obtain an understanding of ~~the following in order to determine whether the internal audit function is likely to be relevant to the audit:~~

- ~~a.~~ ***The*** ~~the~~ nature of the internal audit function’s responsibilities, how the function fits in the entity’s organizational structure, ***and***
- ~~b.~~ ***The*** ~~the~~ activities performed, or to be performed. ~~by the internal audit function~~ (Ref: par. .A104–.A106)

<sup>3</sup> ***Paragraph .13 of AU-C section 610, Using the Work of Internal Auditors, defines the term internal audit function for purposes of GAAS.***

[Footnotes 3–4 renumbered.]

[No amendments to paragraphs .25–.A5.]

***Inquiries of Management and Others Within the Entity (Ref: par. .06[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.***

~~.A7 However, the~~ ***The*** auditor also may 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 toward those charged with governance may help the auditor understand the environment in which the financial statements are prepared. ***AU-C section 260<sup>6</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 directed toward internal audit personnel may provide information about internal audit procedures performed during the year relating to the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to findings from those procedures.~~
- inquiries of employees involved in initiating, authorizing, 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, postsales obligations, arrangements (such as joint ventures) with business partners, and the meaning of contract terms.
- inquiries directed toward marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.
- ***inquiries directed to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.***
- ***inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system-related risks.***

<sup>6</sup> ***AU-C section 260, The Auditor's Communication With Those Charged With Governance, paragraph 5(d).***

***.A8 Because obtaining an understanding of the entity and its environment is a continual, dynamic process, the auditor's inquiries may occur throughout the audit engagement.***

#### ***Inquiries of the Internal Audit Function***

***.A9 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. In performing its 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 its work, such as identified control deficiencies or risks, that may provide valuable input into the***



*auditor's understanding of the entity, the auditor's risk assessments, or other aspects of the audit. The auditor's inquiries are therefore made whether or not 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.<sup>7</sup> Inquiries of particular relevance may be about matters the internal audit function has raised with those charged with governance and the outcomes of the function's own risk assessment process.*

<sup>7</sup> *The relevant requirements are contained in AU-C section 610, Using the Work of Internal Auditors.*

*.A10 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 consider it appropriate to read related reports of the internal audit function. Examples of reports of the internal audit function that may be relevant include the function's strategy and planning documents and reports that have been prepared for management or those charged with governance describing the findings of the internal audit function's examinations.*

*.A11 In addition, in accordance with AU-C section 240,<sup>8</sup> if the internal audit function provides information to the auditor regarding any actual, suspected, or alleged fraud, the auditor takes this into account in the auditor's identification of risk of material misstatement due to fraud.*

<sup>8</sup> *Paragraph .19 of AU-C section 240.*

*.A12 Appropriate individuals within the internal audit function with whom inquiries are made are those who, in the auditor's judgment, have the appropriate knowledge, experience, and authority (such as the chief internal audit executive or, depending on the circumstances, other personnel within the function). The auditor may also consider it appropriate to have periodic meetings with these individuals.*

*Considerations Specific to Governmental Entities (Ref: par. .06a)*

*.A13 Auditors of governmental entities often have additional responsibilities with regard to internal control and compliance with applicable laws and regulations. Inquiries of appropriate individuals in the internal audit function can assist the auditors in identifying the risk of material noncompliance with applicable laws and regulations and the risk of deficiencies in internal control over financial reporting.*

[Paragraphs .A7–.A73 renumbered. Footnotes 6–13 renumbered.]

[Paragraph .A80 included for contextual information only.]

~~.A73~~ *.A80 Audit evidence for elements of the control environment.* 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 through

management's 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.

***.A81 The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified deficiencies in internal control relevant to the audit, including whether and how such responses have been implemented, and whether they have been subsequently evaluated by the internal audit function.***

[Paragraphs .A74–.A103 renumbered.]

***.A112 Internal audit function (Ref: par. .24). If the entity has an internal audit function, obtaining an understanding of that function contributes to the auditor's understanding of the entity and its environment, including internal control; this also includes the role that the function plays in the entity's monitoring of internal control over financial reporting. This understanding, together with the information obtained from the auditor's inquiries in paragraph .06(a), may also provide information that is directly relevant to the auditor's identification and assessment of the risks of material misstatement.***

~~***.A104 .A113 Internal audit function (Ref: par. .24).***~~ The entity's internal audit function is likely to be relevant to the audit if the nature of the internal audit function's responsibilities and activities are related to the entity's financial reporting, and the auditor expects to use the work of the internal auditors to modify the nature or timing or reduce the extent of audit procedures to be performed. If the auditor determines that the internal audit function is likely to be relevant to the audit, section 610, ***Using the Work of Internal Auditors***, ~~*The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*~~,<sup>fn+</sup> applies.

<sup>fn+</sup>~~SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, is currently effective and codified as AU section 322. SAS No. 65 has been included in section 610, as designated by SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, and will be superseded when it is redrafted for clarity and convergence with International Standard on Auditing 610 (Revised), *Using the Work of Internal Auditors*, as part of the Clarification and Convergence project of the Auditing Standards Board. Until such time, section 610 has been conformed to reflect updated section and paragraph cross references but has not otherwise been subjected to a comprehensive review or revision.~~

~~***.A105 .A114***~~ The objectives ***and scope*** of an internal audit function and therefore, the nature of its responsibilities and its status within the organization, ***including the function's authority and accountability***, vary widely and depend on the size and structure of the entity and the requirements of management and, when applicable, those

charged with governance. *These matters may be set out in an internal audit charter or terms of reference.*

~~.A115~~ The responsibilities of an internal audit function may include ~~for example, monitoring of internal control, risk management, and review of compliance with laws and regulations,~~ *performing procedures and evaluating the results to provide assurance to management and those charged with governance regarding the design and effectiveness of risk management, internal control, and governance processes. The internal audit function may play an important role in the entity's monitoring of internal control over financial reporting.* ~~On the other hand~~ *However*, the responsibilities of the internal audit function may be ~~limited to the review focused on evaluating~~ of the economy, efficiency, and effectiveness of operations, ~~for example, and, accordingly, may not relate to the entity's financial reporting and, if so, the work of the function may not directly relate to the entity's financial reporting.~~

*.A116 The auditor's inquiries of appropriate individuals within the internal audit function, in accordance with paragraph .06(a), 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.*

~~.A106 .A117~~ If the nature of the internal audit function's responsibilities *and assurance activities* is ~~is~~ related to the entity's financial reporting, ~~the external auditor's consideration of the activities performed or to be performed by the internal audit function may include review of the internal audit function's audit plan for the period, if any, and discussion of that plan with the internal auditors.~~ *the auditor may 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 directly by the auditor in obtaining audit evidence. Auditors may be more likely to use the work of an entity's internal audit function when it appears, for example, based on experience in previous audits or the auditor's risk assessment procedures in which the entity has an internal audit function that is adequately and appropriately resourced relative to the size of the entity and the nature of its operations, and has a direct reporting relationship to those charged with governance.*

*.A118 If, based on the auditor's preliminary understanding of the internal audit function, 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, AU-C section 610 applies.*

*.A119 As is further discussed in AU-C section 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 that are designed to contribute to how the entity prevents or detects misstatements.*

*.A120 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 significant matters that may come to the attention of the internal audit function when such matters may affect the work of the auditor. AU-C section 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. 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.*

[Paragraphs .A107–.A144 renumbered.]

A43.

## **Appendix B—Proposed Amendment to Statement on Quality Control Standards No. 8 and Other Amendments to SAS No. 122**

### ***Amendment to Statement on Quality Control Standards No. 8, A Firm’s System of Quality Control (Redrafted) (AICPA, Professional Standards, QC sec. 10)***

***Boldface italics*** denotes new language. Deleted text is shown in ~~strikethrough~~.

[No amendments to paragraphs .01–.12.]

#### **Definitions**

**.13** For purposes of SQCSs, the following terms have the meanings attributed as follows:

[Paragraph .13 is reproduced here in part. There are no additional amendments to paragraph .13.]

**Engagement team.** All partners and staff performing the engagement and any individuals engaged by the firm or a network firm who perform procedures on the engagement. This excludes external specialists engaged by the firm or a network firm.<sup>fn 1</sup>

***The term engagement team also excludes individuals within the client’s internal audit function who provide direct assistance on an audit engagement when the external auditor complies with the requirements of AU-C section 610, Using the Work of Internal Auditors.***

<sup>fn 1</sup> [Footnote omitted for purposes of this proposed SAS.]

[No amendments to paragraphs .14–.A81.]

#### ***Other Amendments to SAS No. 122***

***Boldface italics*** denotes new language. Deleted text is shown in ~~strikethrough~~.

### ***AU-C Section 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards***

[No amendments to paragraphs .01–.A76.]

#### ***Complying With Relevant Requirements***

*Relevant Requirements (Ref: par. .24)*

**.A77** In some cases, an AU-C section (and therefore all of its requirements) may not be relevant in the circumstances. For example, if an entity does not have an internal audit function, nothing in section 610, *Using the Work of Internal Auditors, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*,<sup>fn 5</sup> is relevant.

<sup>fn 5</sup> ~~SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, is currently effective and codified as AU section 322. SAS No. 65 has been included in section 610, as designated by SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, and will be superseded when it is redrafted for clarity and convergence with International Standard on Auditing 610 (Revised), *Using the Work of Internal Auditors*, as part of the Clarification and Convergence project of the Auditing Standards Board. Until such time, section 610 has been conformed to reflect updated section and paragraph cross references but has not otherwise been subjected to a comprehensive review or revision.~~

[No amendments to paragraphs .A78–.A86.]

#### **AU-C Section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards***

[No amendments to paragraphs .01–.08.]

#### **Definitions**

**.09** For purposes of GAAS, the following terms have the meanings attributed as follows:

[Paragraph .09 is reproduced here in part. There are no additional amendments to paragraph .09.]

**Engagement team.** All partners and staff performing the engagement and any individuals engaged by the firm or a network firm who perform audit procedures on the engagement. This excludes an auditor's external specialist engaged by the firm or a network firm.<sup>fn 5</sup>

*The term engagement team also excludes individuals within the client's internal audit function who provide direct assistance on an audit engagement when the external auditor complies with the requirements of AU-C section 610, Using the Work of Internal Auditors.*

<sup>fn 5</sup> [Footnote omitted for purposes of this proposed SAS.]

[No amendments to paragraphs .10–.A36.]

#### **AU-C Section 230, *Audit Documentation***

[No amendments to paragraphs .01–.A21.]

**.A22** The documentation requirement applies only to requirements that are relevant in the circumstances. A requirement is not relevant<sup>fn 10</sup> only in the cases in which

- a. the AU-C section is not relevant (for example, if an entity does not have an internal audit function, nothing in section 610, *Using the Work of Internal Auditors* ~~*The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*~~,<sup>fn ‡</sup> is relevant); or
- b. the requirement is conditional and the condition does not exist (for example, the requirement to modify the auditor's opinion when there is an inability to obtain sufficient appropriate audit evidence, and there is no such inability).

<sup>fn 10</sup> [Footnote omitted for purposes of this proposed SAS.]

<sup>fn ‡</sup> ~~Statement on Auditing Standards (SAS) No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, is currently effective and codified as AU section 322. SAS No. 65 has been included in section 610, as designated by SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, and will be superseded when it is redrafted for clarity and convergence with International Standard on Auditing 610 (Revised), *Using the Work of Internal Auditors*, as part of the Clarification and Convergence project of the Auditing Standards Board. Until such time, section 610 has been conformed to reflect updated section and paragraph cross references but has not otherwise been subjected to a comprehensive review or revision.~~

[No amendments to paragraphs .A23–.A30.]

#### **AU-C Section 240, *Consideration of Fraud in a Financial Statement Audit***

[No amendments to paragraphs .01–.18.]

**.19** For those entities that have an internal audit function,<sup>fn 6</sup> the auditor should make inquiries of *appropriate individuals within the internal audit function* to obtain *their* ~~its~~ views about the risks of fraud; determine whether *they have* ~~it has~~ knowledge of any actual, suspected, or alleged fraud affecting the entity; whether *they have* ~~it has~~ performed any procedures to identify or detect fraud during the year; and whether management has satisfactorily responded to any findings resulting from these procedures.

<sup>fn 6</sup> Section 610, *Using the Work of Internal Auditors*, provides guidance in audits of those entities that have an internal audit function. ~~Statement on Auditing Standards (SAS) No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, is currently effective and codified as AU section 322. SAS No. 65 has been included in section 610, as designated by SAS No. 122, *Statements on Auditing Standards: Clarification and Recodification*, and will be superseded when it is redrafted for clarity and convergence with International Standard on Auditing 610 (Revised), *Using the Work of Internal Auditors*, as part of the Clarification and Convergence project of the Auditing Standards Board. Until such time, section 610 has been conformed to reflect~~

~~updated section and paragraph cross references but has not otherwise been subjected to a comprehensive review or revision.~~

## **Appendix A—Examples of Fraud Risk Factors (Ref: par. .11, .24, and .A30)**

**.A75**

[Paragraph .A75 is reproduced here in part. There are no additional amendments to paragraph .A75.]

### **Risk Factors Relating to Misstatements Arising From Fraudulent Financial Reporting**

#### ***Opportunities***

Internal control components are deficient as a result of the following:

- Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (when external reporting is required)
- High turnover rates or employment of ***staff in*** accounting, ~~internal audit, or IT, or~~ ***the internal audit function who*** ~~staff~~ are not effective
- Accounting and information systems that are not effective, including situations involving significant deficiencies or material weaknesses in internal control
- Weak controls over budget preparation and development and compliance with law or regulation.

[No amendments to paragraphs .A77–.A78.]

### **AU-C Section 260, *The Auditor's Communication With Those Charged With Governance***

[No amendments to paragraphs .01–.A19.]

**.A20** Matters communicated may include the following:

- How the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error
- The auditor's approach to internal control relevant to the audit including, when applicable, whether the auditor will express an opinion on the effectiveness of internal control over financial reporting
- The application of materiality in the context of an audit, as discussed in section 320, *Materiality in Planning and Performing an Audit*
- If the entity has an internal audit function, ~~the extent to which~~ ***how the external auditor will use the work of internal audit and how the external and the internal auditors can best work together in a constructive and complementary manner, including any planned use of the work of the internal audit function***



[No amendments to paragraphs .A21–.A37.]

**.A38** Before communicating matters with those charged with governance, the auditor may discuss them with management unless that is inappropriate. For example, it may not be appropriate to discuss with management questions of management’s competence or integrity. In addition to recognizing management’s responsibility, these initial discussions may clarify facts and issues and give management an opportunity to provide further information and explanations. Similarly, when the entity has an internal audit function, the auditor may discuss matters with ~~the~~ ***appropriate individuals within the function*** ~~internal auditor~~ before communicating with those charged with governance.

[No amendments to paragraphs .A39–.A44.]

**.A45** As discussed in paragraph .A1, effective two-way communication assists both the auditor and those charged with governance. Further, section 315 identifies participation by those charged with governance, including their interaction with ~~the~~ ***internal auditors function*** (if any) and external auditors, as an element of the entity’s control environment. Inadequate two-way communication may indicate an unsatisfactory control environment, which will influence the auditor’s assessment of the risks of material misstatements. There is also a risk that the auditor may not have obtained sufficient appropriate audit evidence to form an opinion on the financial statements.

[No amendments to paragraphs .A46–.A49.]

#### **AU-C Section 265, *Communicating Internal Control Related Matters Identified in an Audit***

[No amendments to paragraphs .A1–.A25.]

**.A26** If the auditor has communicated deficiencies in internal control, other than significant deficiencies or material weaknesses, to management in a prior period and management has chosen not to remedy them for cost or other reasons, the auditor need not repeat the communication in the current period. The auditor also is not required to repeat information about such deficiencies if the information has been previously communicated to management by other parties, such as ~~the~~ ***internal auditors function*** or regulators. However, the auditor may consider it appropriate to recommunicate these other deficiencies if there has been a change of management or if new information has come to the auditor’s attention that alters the prior understanding of the auditor and management regarding the deficiencies. Nevertheless, the failure of management to remedy other deficiencies in internal control that were previously communicated may become a significant deficiency requiring communication with those charged with governance. Whether this is the case depends on the auditor’s professional judgment in the circumstances.

[No amendments to paragraphs .A27–.A39.]

#### **AU-C Section 300, *Planning an Audit***

[No changes to paragraphs .01–.A24.]

## **.A25**

**[Paragraph .A25 is reproduced here in part. There are no additional amendments to paragraph .A25.]**

**Appendix—Considerations in Establishing the Overall Audit Strategy (Ref: par. .07–.08 and .A9–.A12)**

### **Characteristics of the Engagement**

The following are some examples of characteristics of the engagement:

- The financial reporting framework on which the financial information to be audited has been prepared, including any need for reconciliations to another financial reporting framework
- Industry specific reporting requirements, such as reports mandated by industry regulators
- The expected audit coverage, including the number and locations of components to be included
- The nature of the control relationships between a parent and its components that determine how the group is to be consolidated
- The extent to which components are audited by other auditors
- The nature of the business divisions to be audited, including the need for specialized knowledge
- The reporting currency to be used, including any need for currency translation for the audited financial information
- The need for statutory or regulatory audit requirements (for example, the Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*)
- ~~The availability of the work of internal auditors and the extent of the auditor's potential use of such work~~ ***Whether the entity has an internal audit function and, if so, whether (in which areas and to what extent) the work of the function can be used, or internal auditors can be used, to provide direct assistance for purposes of the audit***
- The entity's use of service organizations and how the auditor may obtain evidence concerning the design or operation of controls performed by them
- The expected use of audit evidence obtained in previous audits (for example, audit evidence related to risk assessment procedures and tests of controls)
- The effect of IT on the audit procedures, including the availability of data and the expected use of computer assisted audit techniques
- The coordination of the expected coverage and timing of the audit work with any reviews of interim financial information and the effect on the audit of the information obtained during such reviews
- The availability of client personnel and data

**AU-C Section 402, *Audit Considerations Relating to an Entity Using a Service Organization***

[No changes to paragraphs .01–.22.]

**Obtaining an Understanding of the Services Provided by a Service Organization, Including Internal Control**

***Sources of Information (Ref: par. .09)***

**.A1** Information about the nature of the services provided by a service organization may be available from a wide variety of sources, such as the following:

- User manuals
- System overviews
- Technical manuals
- The contract or service level agreement between the user entity and the service organization
- Reports by service organizations, *the* internal auditors *function*, or regulatory authorities on controls at the service organization
- Reports by the service auditor, if available

[No changes to paragraphs .A2–.A44.]

**AU-C Section 500, *Audit Evidence***

[No changes to paragraphs .01–.A51.]

**.A52** In some cases, the auditor may intend to use information produced by the entity for other audit purposes. For example, the auditor may intend to use the entity's performance measures for the purpose of analytical procedures or use the entity's information produced for monitoring activities such as ~~internal auditor's reports~~ *of the internal audit function*. In such cases, the appropriateness of the audit evidence obtained is affected by whether the information is sufficiently precise or detailed for the auditor's purposes. For example, performance measures used by management may not be precise enough to detect material misstatements.

**Inconsistency in, or Doubts Over Reliability of, Audit Evidence (Ref: par. .10)**

**.A53** Obtaining audit evidence from different sources or of a different nature may indicate that an individual item of audit evidence is not reliable, such as when audit evidence obtained from one source is inconsistent with that obtained from another. This may be the case when, for example, responses to inquiries of management, internal audit, and others are inconsistent or when responses to inquiries of those charged with governance made to corroborate the responses to inquiries of management are inconsistent with the response by management. Section 230, *Audit Documentation*,

includes a specific documentation requirement if the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant finding or issue.<sup>fn 14</sup>

<sup>fn 14</sup> [Footnote omitted for purposes of this proposed SAS.]

#### **AU-C Section 550, *Related Parties***

[No changes to paragraphs .01–.A14.]

##### *The Entity's Controls Over Related Party Relationships and Transactions (Ref: par. .15)*

**.A15** Others within the entity are those considered likely to have knowledge of the entity's related party relationships and transactions and the entity's controls over such relationships and transactions. These may include, to the extent that they do not form part of management, the following:

- Those charged with governance
- Personnel in a position to initiate, authorize, process, or record transactions that are both significant and outside the entity's normal course of business and those who supervise or monitor such personnel
- ***The internal auditors' function***
- In-house legal counsel
- The chief ethics officer or equivalent person
- Chief compliance officer

[No changes to paragraph .A16.]

**.A17** In meeting the requirement of section 315 to obtain an understanding of internal control, the auditor may consider features or elements relevant to mitigating the risks of material misstatement associated with related party relationships and transactions, such as the following:<sup>fn 25</sup>

- Internal ethical codes, appropriately communicated to the entity's personnel and enforced, governing the circumstances in which the entity may enter into specific types of related party transactions
- Policies and procedures for open and timely disclosure of the interests that management and those charged with governance have in related party transactions
- The assignment of responsibilities within the entity for identifying, recording, summarizing, and disclosing related party transactions
- Timely disclosure and discussion between management and those charged with governance of significant related party transactions outside the entity's normal course of business, including whether those charged with governance have appropriately challenged the business rationale of such transactions (for example, by seeking advice from external professional advisors)

- Clear guidelines for the approval of related party transactions involving actual or perceived conflicts of interest, such as approval by a subcommittee of those charged with governance comprising individuals independent of management
- Periodic reviews by *the* internal auditors *function*, when applicable
- Proactive action taken by management to resolve related party disclosure issues, such as seeking advice from the auditor or external legal counsel
- The existence of whistle-blowing policies and procedures, when applicable

<sup>fn 25</sup> [Footnote omitted for purposes of this proposed SAS.]

[No changes to paragraphs .A18–.A21.]

### ***Maintaining Alertness for Related Party Information When Reviewing Records or Documents***

*Records or Documents That the Auditor May Inspect (Ref: par. .16)*

**.A22** During the audit, the auditor may inspect records or documents that indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor. Examples of those records or documents include the following:

- Third party confirmations obtained by the auditor (in addition to bank and legal confirmations)
- Entity income tax returns
- Information supplied by the entity to regulatory authorities
- Shareholder registers to identify the entity’s principal shareholders
- Statements of conflicts of interest from management and those charged with governance
- Records of the entity’s investments and those of its benefit plans
- Contracts and agreements with key management or those charged with governance
- Significant contracts and agreements not in the entity’s ordinary course of business
- Specific invoices and correspondence from the entity’s professional advisors
- Life insurance policies acquired by the entity
- Significant contracts renegotiated by the entity during the period
- ~~Internal auditors’~~ ***Reports of the internal audit function***
- Capital financing arrangements with entities other than financial institutions (for example, construction of a governmental entity facility associated with the issuance of debt by a related not-for-profit entity)
- Economic development arrangements for capital additions (for example, a governmental entity’s use and eventual ownership of properties and facilities financed and operated by a company or another governmental entity)

[No changes to paragraphs .A23–.A52.]

**AU-C Section 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)***

[No changes to paragraphs .01–.A34.]

***Fraud (Ref: par. .20)***

**.A35** The auditor is required to identify and assess the risks of material misstatement of the financial statements due to fraud and to design and implement appropriate responses to the assessed risks.<sup>fn 19</sup> Information used to identify the risks of material misstatement of the group financial statements due to fraud may include the following:

- Group management’s assessment of the risks that the group financial statements may be materially misstated as a result of fraud
- Group management’s process for identifying and responding to the risks of fraud in the group, including any specific fraud risks identified by group management or account balances, classes of transactions, or disclosures for which a risk of fraud is likely
- Whether particular components exist for which a risk of fraud is likely
- How those charged with governance of the group monitor group management’s processes for identifying and responding to the risks of fraud in the group and the controls group management has established to mitigate these risks
- Responses of those charged with governance of the group, group management, ***appropriate individuals within the*** ~~and~~ ***internal audit function*** (and, if considered appropriate, component management, the component auditors, and others) to the group engagement team’s inquiry whether they have knowledge of any actual, suspected, or alleged fraud affecting a component or the group

<sup>fn 19</sup> [Footnote omitted for purposes of this proposed SAS.]

[No changes to paragraphs .A36–.A82.]

**.A83** The group engagement team’s decision about how many components to select in accordance with paragraph .56, which components to select, and the type of work to be performed on the financial information of the individual components selected may be affected by factors, such as the following:

- The extent of audit evidence expected to be obtained on the financial information of the significant components
- Whether the component has been newly formed or acquired
- Whether significant changes have taken place in the component
- Whether ***the*** internal audit ***function*** has performed work at the component and any effect of that work on the group audit
- Whether the components apply common systems and processes
- The operating effectiveness of group-wide controls

- Abnormal fluctuations identified by analytical procedures performed at group level
- The individual financial significance of, or the risk posed by, the component in comparison with other components within this category
- Whether the component is subject to an audit required by law or regulation or performed for another reason

Including an element of unpredictability in selecting components in this category may increase the likelihood of identifying material misstatement of the components' financial information. The selection of components is often varied on a cyclical basis.

[No changes to paragraphs .A84–.A93.]

#### **.A94**

**[Paragraph .A94 is reproduced here in part. There are no additional amendments to paragraph .A94.]**

### **Appendix A—Understanding the Group, Its Components, and Their Environments—Examples of Matters About Which the Group Engagement Team Obtains an Understanding (Ref: par. .A31)**

The examples provided cover a broad range of matters; however, not all matters are relevant to every group audit engagement, and the list of examples is not necessarily complete.

#### **Group-Wide Controls**

Group-wide controls may include a combination of the following:

- Regular meetings between group and component management to discuss business developments and review performance
- Monitoring of components' operations and their financial results, including regular reporting routines, which enables group management to monitor components' performance against budgets and take appropriate action
- Group management's risk assessment process (that is, the process for identifying, analyzing, and managing business risks, including the risk of fraud, that may result in material misstatement of the group financial statements)
- Monitoring, controlling, reconciling, and eliminating intragroup account balances, transactions, and unrealized profits or losses at group level
- A process for monitoring the timeliness and assessing the accuracy and completeness of financial information received from components
- A central IT system controlled by the same general IT controls for all or part of the group
- Control activities within an IT system that are common for all or some components

- Monitoring of controls, including activities of **the** internal audit **function** and self-assessment programs
- Consistent policies and procedures, including a group financial reporting procedures manual
- Group-wide programs, such as codes of conduct and fraud prevention programs
- Arrangements for assigning authority and responsibility to component management

~~The~~ internal audit function may be regarded as part of group-wide controls, for example, when the ~~internal audit~~ function is centralized. Section 610, ***Using the Work of Internal Auditors*** ~~The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements~~, addresses the group engagement team's evaluation of ~~the~~ ***whether the internal audit function's organizational status and relevant policies and procedures adequately support the*** ~~competence and objectivity of the internal auditors,~~ ***the level of competence of the internal audit function, and whether the function applies a systematic and disciplined approach*** when ~~the group engagement team expects it plans to use their~~ ***the function's*** work.<sup>fn 1</sup>

<sup>fn 1</sup> Paragraphs .10–.11 of section 610, ***Using the Work of Internal Auditors***. ~~The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements~~. SAS No. 65, ~~The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements~~, is currently effective and codified as AU section 322. SAS No. 65 has been included in section 610, as designated by SAS No. 122, ~~Statements on Auditing Standards: Clarification and Recodification~~, and will be superseded when it is redrafted for clarity and convergence with International Standard on Auditing 610 (Revised), ***Using the Work of Internal Auditors***, as part of the Clarification and Convergence project of the Auditing Standards Board. Until such time, section 610 has been conformed to reflect updated section and paragraph cross references but has not otherwise been subjected to a comprehensive review or revision.

[No changes to paragraph .A95.]

## **.A96**

### **Appendix C—Required and Additional Matters Included in the Group Engagement Team's Letter of Instruction (Ref: par. .A90)**

**[Paragraph .A96 is reproduced here in part. There are no additional amendments to paragraph .A96.]**

The following matters are relevant to the conduct of the work of the component auditor:

- The findings of the group engagement team's tests of control activities of a processing system that is common for all or some components and tests of controls to be performed by the component auditor



- *Identified significant risks of material misstatement of the group financial statements, due to fraud or error, that are relevant to the work of the component auditor and a request that the component auditor communicates on a timely basis any other significant risks of material misstatement of the group financial statements, due to fraud or error, identified in the component and the component auditor's response to such risks*
- The findings of ***the*** internal audit ***function***, based on work performed on controls at or relevant to components
- A request for timely communication of audit evidence obtained from performing work on the financial information of the components that contradicts the audit evidence on which the group engagement team originally based the risk assessment performed at group level
- A request for a written representation on component management's compliance with the applicable financial reporting framework or a statement that differences between the accounting policies applied to the financial information of the component and those applied to the group financial statements have been disclosed
- Matters to be documented by the component auditor

[No changes to paragraphs .A97–.A99.]

A44.

**Exhibit—Comparison of Proposed Statement on Auditing Standards  
*Using the Work of Internal Auditors* With International Standard on  
Auditing 610 (Revised 2013) *Using the Work of Internal Auditors***

This analysis was prepared by the Audit and Attest Standards staff to highlight substantive differences between the proposed Statement on Auditing Standards, *Using the Work of Internal Auditors*, and International Standard on Auditing (ISA) 610 (Revised), *Using the Work of Internal Auditors*, and the rationale therefore. This analysis is not authoritative and is prepared for informational purposes only. It has not been acted on or reviewed by the Auditing Standards Board (ASB).

The ASB also made various changes to the language throughout the proposed SAS in comparison with ISA 610 (Revised 2013). Such changes were made to use terms applicable in the United States and to make the proposed SAS easier to read and apply. The ASB believes that such changes will not create differences between the application of ISA 610 (Revised 2013) and the application of the proposed SAS and, accordingly, these differences are not subsequently discussed.

**Using Internal Auditors to Provide Direct Assistance**

Substantive differences related to the requirements of the proposed SAS and ISA 610 (Revised 2013) are subsequently described.

*Determining the Nature and Extent of Work That Can Be Assigned to Internal Auditors  
Providing Direct Assistance*

The ASB decided to delete paragraph 30 of ISA 610 (Revised 2013), which requires the external auditor not to use internal auditors to provide direct assistance in specified circumstances. The ASB believes that the requirements in paragraphs 30a and 30b are overly prescriptive and partly redundant when compared to the requirement in paragraph 29 of ISA 610 (Revised 2013) regarding the application of judgment in terms of the nature and extent of work to assign to internal auditors and the nature, timing, and extent of the review thereof. Additional application guidance was added to further emphasize that as materiality, risks, or the amount of judgment involved increase, the need for the external auditor to perform procedures directly increases. The ASB did not consider the requirements in paragraphs 30c and 30d necessary, as an appropriate assessment of objectivity would result in a conclusion that it would not be appropriate for internal auditors work to be used in that way.

Paragraph 31 of ISA 610 (Revised 2013) establishes a requirement that, in communicating with those charged with governance an overview of the planned scope and timing of the audit in accordance with ISA 260, *Communication with Those Charged with Governance*, the external auditor should communicate the nature and extent of the planned use of internal auditors to provide direct assistance *so as to reach a mutual*

*understanding that such use is not excessive in the circumstances of the engagement.* The ASB decided to revise paragraph 31 of ISA 610 (Revised 2013) to improve the clarity of the requirement and to eliminate the requirement to explicitly obtain the agreement of those charged with governance that the proposed nature and extent of the use of internal auditors to provide direct assistance is not excessive because it was not considered necessary in the context of audits of nonissuers in the United States. Making the communication required by paragraph 29 of the proposed SAS provides those charged with governance the opportunity to voice any concerns.

#### *Using Internal Auditors to Provide Direct Assistance*

Paragraph 32 of ISA 610 (Revised 2013) requires the auditor to evaluate whether, in aggregate, using internal auditors to provide direct assistance to the extent planned, together with the planned use of the work of the internal audit function, would still result in the external auditor being sufficiently involved in the audit, given the external auditor's sole responsibility for the audit opinion expressed. This requirement was deleted because the ASB believes that it is a redundant requirement (that is, the auditor has sole responsibility for his or her audit opinion, regardless of whether the auditor uses the work of internal auditors or not). In accordance with paragraph .10 of AU-C section 220, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, the engagement partner should take responsibility for the overall quality on each audit engagement to which that partner is assigned.

Paragraph 33 of ISA 610 (Revised 2013) requires that, prior to using internal auditors to provide direct assistance for purposes of the audit, the external auditor (1) obtain written agreement from an authorized representative of the entity that the internal auditors will be allowed to follow the external auditor's instructions, and that the entity will not intervene in the work the internal auditor performs for the external auditor, and (2) obtain written agreement from the internal auditors that they will keep confidential specific matters as instructed by the external auditor and inform the external auditor of any threat to their objectivity. The ASB deleted this requirement because, based on historical experience, it is not believed that this requirement is necessary for the audits of nonissuers in the United States.

Paragraph 34a of ISA 610 (Revised 2013) states the following:

[t]he external auditor shall direct, supervise and review the work performed by internal auditors on the engagement in accordance with ISA 220. In so doing: *a.* The nature, timing and extent of direction, supervision, and review shall recognize that the internal auditors are not independent of the entity and be responsive to the outcome of the evaluation of the factors in paragraph 29 of this ISA

In paragraph 30(a) of the proposed SAS, the ASB decided to delete the phrase *recognize that the internal auditors are not independent of the entity* because it is unclear as to what the incremental effect of the phrase is on the nature, timing, and extent of the external auditor's actions. The ASB also believes that the fact that internal auditors are not

independent of the entity is already encompassed by the evaluation of the factors in paragraph 28 of the proposed SAS.

In addition, the ASB decided to add paragraph 30(b), which represents a requirement to instruct internal auditors to bring accounting and auditing issues to the attention of the external auditors. The ASB believes that it is important to retain this requirement from extant AU-C section 610, *Using the Work of Internal Auditors*.

Finally, in paragraph 30(c) the ASB decided to revise paragraph 34*b* of ISA 610 (Revised 2013) to express the requirement in more common terms used in extant AU-C section 610.