



**COMMITTEE OF EUROPEAN SECURITIES REGULATORS**  
**THE CHAIRMAN**

Technical Director  
IAASB  
545 Fifth Avenue, 14th Floor  
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**RE: Consultation on the proposed revisions to International Standard on Auditing (ISA) 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, and ISA 610, *Using the Work of Internal Auditors*.**

The Committee of European Securities Regulators (CESR), through its Corporate Reporting Standing Committee, has considered the exposure draft (ED) issued by the IAASB on the ISA 315 and ISA 610.

CESR believes that the matters addressed in this ED are of great importance from the point of view of the securities regulators. Indeed large companies and groups listed in the European markets have internal audit functions that play an important role within their organizational structures and fruitful relationships between internal and external auditors could be built with the aim of providing benefits for their respective objectives.

However CESR has noticed that in the ED these relationships have been dealt on the basis of a new approach, which we believe has widened the possibility to use the work of the internal audit function. While we acknowledge that the explicit inclusion of auditors obtaining direct assistance from internal auditors has been made in order to provide greater clarity in this area, CESR has various concerns about the ED as a whole. The key concerns are set out below and more detailed observations are shown in Appendix 1.

The ED seems to be based on the premise that where companies have an internal audit function, subject to the performance of certain procedures on the objectivity, level of competence and working approach of the function, the external auditor can use the work of the internal audit function and/or obtain direct assistance from internal auditors to a very large extent and potentially in all areas of the audit work. The ED pays insufficient attention to the threats to auditors' independence and objectivity arising from this approach.

The critical issue in using the work of the internal audit function and/or obtaining direct assistance from internal auditors is the existence of an unavoidable threat that the work performed in such a way has not been carried out with the expected level of independence, certainly without the same level of independence that is required to external auditors. As a consequence, extensive use of the internal audit work, as well as inappropriate use in risky areas of the audit work, raises concerns from the point of view of securities regulators pursuing investor protection and therefore interested in the quality of listed entities audits carried out by independent auditors. In this regard, direct assistance is particularly critical, given that, as explicitly recognized by the ED, the independence threats are greatest in this case. CESR believes that the threats posed by direct assistance are such that it should be prohibited or very limited and clearly restricted to low risk areas.

The internal audit function is set up to serve the needs of the company and cannot be independent in the same way as the external audit is. Therefore, when external auditors wish to rely on its work for their own purposes, they should evaluate the internal audit function and the work done by this



function in order to verify whether appropriate conditions are in place and then take a decision as to whether reliance over this function and its work is appropriate. CESR believes a more rigorous approach should be required by external auditors in determining the nature and extent of their reliance on the internal audit function, and in particular that the ED should be clearer in identifying circumstances where the internal audit function cannot be used and in establishing appropriate safeguards to deal with threats to auditor independence.

Our detailed comments are set out in the Appendix to this letter.

We hope that you find our comments helpful and would be happy to discuss all or any of these issues further with you.

Yours sincerely,

Carlos Tavares



## **Appendix 1 – CESR’s detailed comments with respect to some areas included in the proposed revised standards**

### **Question 1**

**Do respondents believe it is appropriate to require the external auditor to make inquiries of appropriate individuals within the internal audit function? If so, do respondents agree such a requirement is appropriately placed in ISA 315?**

CESR notes the amendments made to ISA 315 and finds it appropriate to require the external auditor to make inquiries of appropriate individuals within the internal audit function as one of the mandatory procedures when assessing the risk of material misstatement.

### **Question 2**

**Do respondents believe that appropriate factors have been proposed to be evaluated by the external auditor in determining:**

- (a) Whether the work of the internal audit function can be used for purposes of the audit engagement; and**
- (b) The planned use of the work of the internal audit function?**

#### **(a)**

CESR believes that the factors proposed to be evaluated by the external auditor in determining whether the work of the internal audit function can be used are appropriate (objectivity, level of competence and working approach of the function).

We agree that the auditor should be required not to use the work of the internal audit function when the function’s degree of objectivity or its level of competence is low. However, we note that no consequences seem to derive from the analysis of the working approach of the function. It should be required that when the outcome of the analysis on the activities of the internal audit function is unsatisfactory the auditor shall not use the work of the function.

We also believe that it would be clearer for paragraph 14 to be expressed more directly and in the positive form, rather than the negative (for example “The external auditor shall only use the work of the internal audit function if it has a high degree of objectivity and a high level of competence”).

#### **(b)**

ISAs are based on the Audit Risk Model where the risk assessment plays a pivotal role in the overall audit process. The new ED (in contrast with the current version of ISA 610) does not require the identified and assessed risks of material misstatements to be taken into account in determining to what extent the work of the internal audit function may be used in a particular area. Instead, the ED requires the amount of judgment involved in performing the audit procedures to be considered (par.15). This criterion does not seem to be sufficient to provide a sound basis for determining the use of the work of the internal audit function. It is very unclear how the amount of judgment can be weighted and evaluated beforehand while the risk assessment is based on the procedures required by ISA 315.

Indeed, the application material in A13 makes a reference to the risk assessment, stating that the higher the assessed risks of material misstatement, the more persuasive the audit evidence required by the external auditor will need to be, and, therefore, the more likely it will be that the external auditor will need to perform more of the work directly. This is an important reminder that, however, is not mandatory.



CESR believes the ED should be strengthened to provide, in addition to the current reference to the amount of judgment, for an obligation to consider the level of the assessed risks of material misstatement when determining the use of the work performed by the internal audit function. The ED should require that the higher the risks of material misstatements, the less reliance external auditors can place on the work performed by internal auditors, particularly in areas where significant risks have been identified.

### **Question 3**

**Do respondents believe it is appropriate to require the external auditor to read reports produced by the internal audit function relating to the work of the internal audit function that is planned to be used by the external auditor?**

The ED requires (par.19) that the external auditor performs audit procedures that are appropriate in the circumstances on the work of the internal audit function to determine its adequacy for the purposes of the audit engagement. However the nature, timing and extent of the audit procedures that the external auditor can perform (including possible re-performance of some work) is addressed only in the application material (A19 and A20), and so does not have mandatory status. The IAASB should consider whether there should be a minimum level of procedures that have been performed in all cases before external auditors can rely on the work of the internal audit function.

CESR believes that the current requirement is not sufficient to prevent “over-reliance” on the audit evidence provided by the internal audit function. Therefore the ED should require that the nature, timing and extent of the audit procedures performed to review the internal audit work be linked to the level of risk associated with the area covered by internal auditors and, in addition to this, that external auditors should perform some testing of the work of the internal audit function to verify its adequacy.

### **Question 4**

**Do respondents believe that it is desirable for the scope of ISA 610 to be expanded to address the matter of direct assistance? If so, do respondents believe that when obtaining the direct assistance of internal auditors the external auditor should be required to:**

- (a) Consider the factors that have been proposed in determining the work that may be assigned to individual internal auditors; and**
- (b) Direct, supervise, and review the audit procedures performed by the internal auditors in a way that recognizes they are not independent of the entity?**

#### **(a)**

The ED addresses two situations of possible involvement of the internal audit function in the external audit work:

- a) using the work of the internal audit function; and
- b) obtaining direct assistance from internal auditors under the direction and supervision of the external auditor.

First of all, CESR notes that the distinction between the two situations is not always be clear cut, and confusion may be possible in some cases. However the distinction is important because the two situations are different in terms of threats to the external auditor’s independence.

In case of direct assistance, the internal audit staff can be considered, in substance, as part of the engagement team. Indeed, ISA 220 defines the engagement team as all personnel performing the engagement, including any individuals who perform audit procedures. If internal auditors providing direct assistance are in substance members of the engagement team, it should be considered whether or not they have to comply with the independence rules applicable to external auditors. The ED is silent in this regard. The auditor that obtains direct assistance only has an obligation to evaluate the “degree of objectivity” (par.20) of internal auditors and “shall recognize that internal auditors are not



independent of the entity” (par.24). The ED does not require any clear actions or safeguards that should be put in place to mitigate this threat to independence.

CESR believes that internal audit staff should not be exempted from the independence requirements which apply to all other individuals directly involved in the audit, and that this area should be addressed in the final document. In any case, it will be impossible to avoid the underlying conflict arising from the fact that internal auditors are hired by the audited company and therefore they will never be totally independent.

Furthermore the ED provides that the external auditors may assign external audit work to individual internal auditors, applying similar considerations to those used in determining what reliance should be placed on the work of the internal audit function. It therefore seems that external audit procedures relating to areas of significant risk could be assigned to internal auditors if they are not deemed to involve making significant judgments. Moreover, the amount of direction, supervision and review of work performed by internal audit staff can be determined considering the degree of objectivity and level of competence of internal auditors, the nature and scope of work to be performed and the amount of judgment involved.

We have concerns about whether these limits on the use of direct assistance are sufficiently robust, and believe that the considerations made with reference to the extent of the use of the internal audit function (point 2 above) and the extent of the auditor’s review of the work done by the internal audit function (point 3 above) are, even more, valid here.

Therefore CESR believes that there should be an explicit obligation to consider the level of the assessed risks of material misstatement when determining the work to be done by internal auditors and that the nature, timing and extent of the audit procedures performed to review the internal auditors’ work should also be explicitly linked to the level of risk associated with the area covered by the work performed. Also, some testing of the work of internal auditors should be performed to verify its adequacy.

CESR believes that direct assistance is particularly critical given the unavoidable independence threats, and that it should be prohibited or explicitly limited to low risk areas where little or no judgment is required.

**(b)**

There are areas of work where the auditor decides to use external confirmations that provide reliable audit evidence obtained from external sources. When using external confirmation procedures, because of the reliance attached to these procedures, according to ISA 505 the auditor shall maintain control over external confirmation requests.

CESR believes that it would be consistent with the approach followed in ISA 505 to require auditors not to use the work of the internal audit function or to obtain direct assistance to send confirmation requests, receive confirmation responses or evaluate the evidence obtained from performing confirmation procedures.