

EXPOSURE DRAFT

ED 31/05
(December 2005)

Proposed Auditing Standard: Considering the Work of Internal Audit (Re-issuance of AUS 604)

Prepared and Issued by the **Auditing and Assurance Standards Board**



Australian Government

Auditing and Assurance Standards Board

Commenting on this Exposure Draft

Comments on this Exposure Draft should be forwarded so as to arrive by 31 January 2006. Comments should be addressed to:

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A copy of all non-confidential submissions will be placed on public record on the AUASB website: www.auasb.gov.au.

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PREFACE

Reasons for Issuing ED 31/05

The Auditing and Assurance Standards Board (AUASB) is proposing to re-issue Auditing Standard (AUS 604) *Considering the Work of Internal Audit* due to the requirements of the legislative provisions explained below.

The *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2001* (the CLERP 9 Act) established the AUASB as an independent statutory body under section 227A of the *Australian Securities and Investments Commission Act 2001*, as from 1 July 2004. Under section 336 of the *Corporations Act 2001*, the AUASB may make Auditing Standards for the purposes of the corporations legislation. These Auditing Standards will be legislative instruments under the *Legislative Instruments Act 2003*.

Main Proposals

This proposed Auditing Standard provides mandatory requirements and explanatory guidance on to external auditors in considering the work of internal auditing.

Proposed Operative Date

It is intended that this proposed Auditing Standard will be operative for financial reporting periods commencing on or after 1 July 2006.

Main changes from existing AUS 604 (October 1995)

The main differences between this proposed Auditing Standard and the Auditing Standard issued by the former Auditing & Assurance Standards Board of the Australian Accounting Research Foundation that it supersedes, AUS 604 (October 1995), is that in this proposed Auditing Standard:

1. the word 'shall', in the **bold-type** paragraphs, is the terminology used to describe an auditor's mandatory requirements, whereas an auditor's degree of responsibility was previously described by the word 'should';
2. the explanatory paragraphs provide guidance and illustrative examples to assist the auditor in fulfilling the mandatory requirements, whereas previously some obligations were implied within certain explanatory paragraphs. Accordingly, such paragraphs have been redrafted to clarify that the matter forms part of the explanatory guidance.
3. the terminology and overall concepts have been aligned to the Audit Risk Standards. The issue and re-issue of the Audit Risk Standards in February 2004, comprising:
 - *AUS 202 Objective and General Principles Governing an Audit of a Financial Report;*
 - *AUS 402 Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement;*
 - *AUS 406 The Auditors Procedures in Response to Assessed Risks;* and
 - *AUS 502 Audit Evidence*gave rise to necessary conforming amendments to certain existing AUSs, including AUS 604.
4. The terminology has been changed to recognise the distinct role of those charged with governance and management.

A Table of Proposed Changes is provided as an attachment to the Exposure Draft.

Proposed Auditing Standard: *Considering the Work of Internal Audit*
(Re-issuance of AUS 604)

Request for Comments

Comments are invited on this Exposure Draft of the proposed re-issuance of Auditing Standard (AUS 604) *Considering the Work of Internal Audit* by 31 January 2006. The AUASB would prefer that respondents express a clear overall opinion on whether the proposed Auditing Standard, as a whole, is supported and that this opinion be supplemented by detailed comments, whether supportive or critical, on any matter. The AUASB regards both critical and supportive comments as essential to a balanced review of the proposed Auditing Standard.

Proposed Auditing Standard: *Considering the Work of Internal Audit*
(*Re-issuance of AUS 604*)

AUTHORITY STATEMENT

The Auditing and Assurance Standards Board (AUASB) makes Auditing Standard <<>> *Considering the Work of Internal Auditing* as set out in paragraphs 1 to 24 and Appendix 1, pursuant to section 227B of the *Australian Securities and Investments Commission Act 2001* and section 336 of the *Corporations Act 2001*.

This Auditing Standard is to be read in conjunction with the *Preamble to AUASB Standards*, which sets out the intentions of the AUASB on how the Auditing Standards are to be understood, interpreted and applied.

The mandatory requirements of this Auditing Standard are set out in **bold-type** paragraphs.

AUDITING STANDARD

Considering the Work of Internal Audit

Application

- 1 **This Auditing Standard applies to:**
 - (a) **an audit of a financial report for a financial year, or an audit of a financial report for a half-year, in accordance with Part 2M.3 of the *Corporations Act 2001*; and**
 - (b) **an audit of a financial report for any other purpose.**
- 2 This Auditing Standard also applies, as appropriate, to an audit of other financial information.

Operative Date

- 3 **This Auditing Standard is operative for financial reporting periods commencing on or after 1 July 2006.**

Introduction

- 4 The purpose of this Auditing Standard is to establish mandatory requirements and to provide explanatory guidance to external auditors in considering the work of internal auditing. This Auditing Standard does not deal with instances when personnel from internal auditing assist the external auditor in carrying out external audit procedures. The audit procedures noted in this Auditing Standard are ordinarily only applied to internal auditing activities which are relevant to the audit of the financial report.
- 5 **The external auditor shall consider the activities of internal auditing and their effect, if any, on external audit procedures.**
- 6 “Internal auditing” means an appraisal activity established within an entity as a service to the entity. Its functions include, amongst other things, monitoring internal control.
- 7 While, pursuant to AUS 202 *Objective and General Principles Governing the Audit of a Financial Report*, the external auditor has sole responsibility for the audit opinion expressed and for determining the nature, timing and extent of external audit

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procedures, certain parts of internal auditing work may be useful to the external auditor.

Scope and Objectives of Internal Auditing

- 8 The scope and objectives of internal auditing vary widely and depend on the size and structure of the entity and the requirements of those charged with governance. Ordinarily, internal auditing activities include one or more of the following:
- Monitoring of internal control. The establishment of adequate internal control is a responsibility of those charged with governance which demands proper attention on a continuous basis. Internal auditing is ordinarily assigned specific responsibility by those charged with governance for reviewing controls, monitoring their operation and recommending improvements thereto.
 - Examination of financial and operating information. This may include review of the means used to identify, measure, classify and report such information and specific inquiry into individual items including detailed testing of transactions, balances and procedures.
 - Review of the economy, efficiency and effectiveness of operations including non-financial controls of an entity.
 - Review of compliance with laws, regulations and other external requirements and with management policies and directives and other internal requirements.

Relationship Between Internal Auditing and the External Auditor

- 9 The role of internal auditing is determined by those charged with governance, and its objectives differ from those of the external auditor who is, pursuant to AUS 202, required to report independently on the financial report. The internal audit function's objectives vary according to the requirements of those charged with governance. The external auditor's primary concern is whether the financial report is free of material misstatements.
- 10 Nevertheless some of the means of achieving their respective objectives are often similar and thus certain aspects of internal auditing may be useful in determining the nature, timing and extent of external audit procedures.

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- 11 Internal auditing is part of the entity. Irrespective of the degree of autonomy and objectivity of internal auditing, it cannot achieve the same degree of independence as required of the external auditor when expressing an opinion on the financial report. Pursuant to AUS 202, the external auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by any use made of internal auditing. All judgements relating to the audit of the financial report are those of the external auditor.

Understanding and Preliminary Assessment of Internal Auditing

- 12 **The external auditor shall obtain a sufficient understanding of internal audit activities to identify and assess the risks of material misstatement of the financial report and to design and perform further audit procedures.**
- 13 Effective internal auditing will often allow a modification in the nature and timing, and a reduction in the extent of audit procedures performed by the external auditor but cannot eliminate them entirely. In some cases, however, having considered the activities of internal auditing, the external auditor may decide that internal auditing will have no effect on external audit procedures.
- 14 **The external auditor shall perform an assessment of the internal audit function when internal auditing is relevant to the external auditor's risk assessment.**
- 15 The external auditor's assessment of the internal audit function will influence the external auditor's judgement about the use which may be made of internal auditing in making risk assessments and thereby modifying the nature, timing and extent of further external audit procedures.
- 16 When obtaining an understanding and performing an assessment of the internal audit function, the important criteria are ordinarily the following:
- (a) Organizational status: Specific status of internal auditing in the entity and the effect this has on its ability to be objective. Generally, internal auditing will report to the highest level of management and/or those charged with governance and be free of any other operating responsibility. Any constraints or restrictions placed on internal auditing by management or those charged with governance would ordinarily be carefully considered. In

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particular, the internal auditors will need to be free to communicate fully with the external auditor.

- (b) Scope of function: The nature and extent of internal auditing assignments performed. The external auditor would also ordinarily consider whether management and those charged with governance act on internal audit recommendations and how this is evidenced.
 - (c) Technical competence: Whether internal auditing is performed by persons having adequate technical training and proficiency as internal auditors. The external auditor may, for example, review the policies for hiring and training the internal auditing staff and their experience and professional qualifications.
 - (d) Due professional care: Whether internal auditing is properly planned, supervised, reviewed and documented. The existence of adequate audit manuals, work programs and working papers would ordinarily be considered.
- 17 A suggested questionnaire to assist in obtaining an understanding and making a preliminary assessment of internal auditing is attached at Appendix 1.

Timing of Liaison and Coordination

- 18 When planning to use the work of internal auditing, the external auditor will ordinarily need to consider internal auditing's tentative plan for the period and discuss it at as early a stage as possible. Where the work of internal auditing is to be a factor in determining the nature, timing and extent of the external auditor's procedures, it is desirable to agree in advance the timing of such work, the extent of audit coverage, materiality levels and proposed methods of sample selection, documentation of the work performed and review and reporting procedures.
- 19 Liaison with internal auditing is ordinarily more effective when meetings are held at appropriate intervals during the period. The external auditor would ordinarily be advised of and have access to relevant internal auditing reports and be kept informed of any significant matter that comes to the internal auditor's attention which may affect the work of the external auditor. Similarly, the external auditor would ordinarily inform the internal auditor of any significant matters which may affect internal auditing.

Evaluating the Work of Internal Auditing

- 20** **When the external auditor intends to use specific work of internal auditing, the external auditor shall evaluate and perform audit procedures on that work to confirm its adequacy for the external auditor's purposes.**
- 21 Pursuant to paragraph 20 of this Auditing Standard, the auditor is required to evaluate the specific work of internal auditing which involves consideration of the adequacy of the scope of work and related programs and whether the assessment of the internal auditing remains appropriate. This evaluation may include consideration of whether:
- (a) the work is performed by persons having adequate technical training and proficiency as internal auditors and the work of assistants is properly supervised, reviewed and documented;
 - (b) sufficient appropriate audit evidence is obtained to be able to draw reasonable conclusions;
 - (c) conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of the work performed; and
 - (d) any exceptions or unusual matters disclosed by internal auditing are properly resolved.
- 22 The nature, timing and extent of the audit procedures performed on the specific work of internal auditing will depend on the external auditor's judgement as to the risk of material misstatement of the area concerned, the assessment of internal auditing and the evaluation of the specific work by internal auditing. Such audit procedures may include examination of items already examined by internal auditing, examination of other similar items and observation of internal auditing procedures.
- 23 Pursuant to AUS 208 *Audit Documentation*, the external auditor is required to record conclusions regarding the specific internal auditing work that has been evaluated and the audit procedures performed on the internal auditor's work.

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Conformity with International Standards on Auditing

24 Except as noted below, this Auditing Standard conforms with International Standard on Auditing ISA 610 *Considering the Work of Internal Audit* issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants. The main difference between this Auditing Standard and ISA 610 is:

- This Auditing Standard includes in Appendix 1 a questionnaire which assists the auditor in obtaining an understanding and making a preliminary assessment of internal auditing, whereas ISA 610 does not.

Compliance with this Auditing Standard enables compliance with ISA 610.

APPENDIX 1

**INTERNAL AUDITING – UNDERSTANDING AND
PRELIMINARY ASSESSMENT QUESTIONNAIRE**

The answers to the following questions may assist in obtaining an understanding and making a preliminary assessment of internal auditing.

Questionnaire	Yes	No	N/A
<i>Organisational Status</i>			
1			
Do those charged with governance's and/or management's view of internal auditing appear not to limit internal auditing?			
2			
Is the head of internal auditing free from:			
(a) the influences of operational management?			
(b) any operating responsibility?			
3			
Does the head of internal auditing have:			
(a) direct access (in case of need) to:			
(i) the governing body?			
(ii) the chairman of the governing body?			
(iii) the chief executive?			
(iv) the audit committee (if applicable)?			
(b) freedom/flexibility from direct instruction from those charged with governance as to the scope and direction of audit activity?			
(c) freedom to communicate with the external auditor on relevant matters on a regular basis?			

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Questionnaire	Yes	No	N/A
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Organisational Status – continued

(If the answer to any of questions 2(a) or (b) or 3(a) to (c) is negative, describe how objectivity is achieved and maintained.)

Scope of Function

- 4 (a) Does internal auditing regularly examine the controls over all significant accounting operations which affect the financial report? (If not, describe the areas not covered by internal auditing.)
- (b) Does the head of internal auditing have flexibility to act using discretion on suggestions made by the external auditor as to areas to be included in the internal auditing program?
- (c) Do internal auditing reports and working papers indicate that internal auditing applies a professional approach to audit assignments?
- 5 (a) (i) Do internal auditing reports identify weaknesses/problems and contain recommendations for improvements?
- (ii) Are such reports addressed to the appropriate level of those charged with governance capable and able to achieve satisfactory audit results?
- (iii) Are copies of all reports forwarded to:
- the chairman of the governing body or chief executive? and/or
 - the audit committee? (if applicable).

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Questionnaire	Yes	No	N/A
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Scope of Function – continued

- (b) Are copies of all reports relating to accounting and associated records available to the external auditor?

(If 5(a) or (b) are answered in the negative, describe the method of reporting.)

- 6 (a) Is there evidence, for example in the minutes of governing body and/or audit committee meetings that internal auditing reports have been considered?
- (b) Is there evidence that a person of senior authority, for example the chief executive, has taken action to see that internal auditing recommendations are properly considered?

(If the answer to 6(a) or 6(b) is negative, describe the process for ensuring that consideration is given to internal auditing reports and recommendations.)

Technical Competence

- 7 Is the head of internal auditing a professionally trained auditor? (If not, describe qualifications by training and by experience for the position held.)
- 8 (a) Do the entity's hiring and/or internal promotion/transfer policies for internal auditing require:
- (i) tertiary qualifications?
 - (ii) formal professional qualifications?
 - (iii) previous audit experience?

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Questionnaire	Yes	No	N/A
<i>Technical Competence – continued</i>			
(b) Does the entity provide internal auditing staff with the opportunity to maintain professional competence, for example by encouraging:			
(i) internal staff training?			
(ii) attendance at external training and professional courses?			
9 Do assignments undertaken reflect those charged with governance confidence in internal auditing, and provide experience in audit related work?			
10 Do the reports prepared by internal auditing reflect a clear understanding of the audit task undertaken and the expression of valid conclusions?			
11 If the entity has a large internal auditing function, does it contain an adequate proportion of professionally trained/experienced auditors?			

Due Professional Care

- 12 (a) Does internal auditing have a procedures manual clearly describing staff responsibilities and audit procedures concerning documentation?
- (b) Is the work of internal auditing controlled and supervised through managers or supervisors responsible to the head of the department, each of whom supervises the work of staff allocated?
- 13 (a) Does internal auditing use written audit programs prepared in conformity with appropriate professional standards and practice?

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Questionnaire	Yes	No	N/A
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Due Professional Care – continued

- (b) Are programs regularly revised and reviewed by appropriate internal auditing staff?
- 14 (a) Does internal auditing prepare working papers to record work done and conclusions drawn?
- (b) Are the working papers reviewed by appropriate internal auditing staff?

(If the answer to any of questions 12 to 14 is negative describe the process used for planning, supervising, reviewing and documenting internal auditing work.)

Table of Proposed Changes from AUS 604 <i>Considering the Work of Internal Audit</i>

Base Standard

ISA 610 *Considering the Work of Internal Audit* was used as the base standard when drafting this proposed Auditing Standard.

Main differences between the Base Standard and the existing AUS 604

The main differences between ISA 610 and the existing AUS 604 are:

1. AUS 604 includes in Appendix 1 a questionnaire which assists the auditor in obtaining an understanding and making a preliminary assessment of internal auditing, whereas ISA 610 does not.
2. the terminology and overall concepts have been aligned to the Audit Risk Standards. The issues and re-issue of the Audit Risk Standards in February 2004, comprising:
 - AUS 202 *Objective and General Principles Governing an Audit of a Financial Report*;
 - AUS 402 *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement*;
 - AUS 406 *The Auditors Procedures in Response to Assessed Risks*; and
 - AUS 502 *Audit Evidence*

gave rise to necessary conforming amendments to certain existing AUSs, including AUS 604.

Table of Proposed Changes from the Base Standard

The table below details the proposed changes from the base standard, ISA 604 (excluding changes to reflect Australian terminology and references to Auditing Standards in Australia).

Paragraph No. in Proposed Exposure Draft	Status (Requirement, Guidance, Footnote or Appendix)	Description of Proposed Change(s)
1,2	Requirement / Guidance	New Application paragraphs.
3	Requirement	Re-position Operative Date paragraph.

Paragraph No. in Proposed Exposure Draft	Status (Requirement, Guidance, Footnote or Appendix)	Description of Proposed Change(s)
5, 12, 14, 20	Requirement	Replace “should” with “shall”.
16, 17, 19	Guidance	Insert “ordinarily,” to remove implied obligations .
7, 9, 21, 23	Guidance	Insert: “pursuant to..... the auditor is required to”.
17	Guidance	Insert: “A suggested questionnaire to assist in obtaining an understanding and making a preliminary assessment of internal auditing is attached as an Appendix”.
N/A	Guidance	Delete Public Sector Perspective paragraph as proposed standard is sector neutral.
16(a)	Guidance	Replace: “In the ideal situation, internal auditing will report to the highest level of management and be free of any other operating responsibility. Any constraints or restrictions placed on internal auditing by management would need to be carefully considered”. with “Generally, internal auditing will report to the highest level of management and/or those charged with governance and be free of any other operating responsibility. Any constraints or restrictions placed on internal auditing by management or those charged with governance would ordinarily be carefully considered”.
16(b)	Guidance	Add “and those charged with governance”.