

**Third Edition**  
**CIA**  
**Preparatory Program**

**Part 1**  
*Sample*

**The Internal Audit Activity's Role  
In Governance, Risk and Control**

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## **Editorial Notes**

Throughout these materials, we have chosen particular language, spellings, structures and grammar in order to be consistent and comprehensible for all readers. HOCK study materials are used by candidates from countries throughout the world, and for many, English is a second language. We are aware that our choices may not always adhere to “formal” standards, but our efforts are focused on making the study process easy for all of our candidates. Nonetheless, we continue to welcome your meaningful corrections and ideas for creating better materials.

This material is designed exclusively to assist people in their exam preparation. No information in the material should be construed as authoritative business, accounting or consulting advice. Appropriate professionals should be consulted for such advice and consulting.

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## Exam Introduction

Each CIA Exam is 150 minutes (2 hours 30 minutes) long and consists of 90 multiple-choice questions. For more information about the exams, visit the IIA's website at: [www.theiia.org](http://www.theiia.org)

The syllabus of the Institute of Internal Auditors (IIA) has six sections for Part 1. These sections and the percentages of the Exam that they represent are:

- 1) Comply with IIA's Attribute Standards (15-25%).
- 2) Establish a Risk-based Plan to Determine the Priorities of the Internal Audit Activity (15-25%)
- 3) Understand the Internal Audit Activity's Role in Organizational Governance (10-20%).
- 4) Perform Other Internal Audit Roles and Responsibilities (0-10%).
- 5) Governance, Risk, and Control Knowledge Elements (15-25%).
- 6) Plan Engagements (15-25%).

### HOCK Study Section Listing

We believe that the material is best presented in five sections. These five sections are:

**Section A** – Comply with IIA's Attribute Standards (15-25%).

**Section B** – Managing the Internal Audit Activity (15-25%).

**Section C** – Internal Audit Activity's Role and Responsibility in Risk Management and Governance (15–25%).

**Section D** – Understanding Internal Control and the Control Processes (20-30%).

**Section E** – Engagement Planning (15-25%).

Additionally, the IIA syllabus refers to **Proficiency** and **Awareness** levels:

- **Proficiency** – Candidates must exhibit proficiency (thorough understanding and ability to apply concepts).
- **Awareness** – Candidates must exhibit awareness (knowledge of terminology and fundamentals).

In your preparations for the Exam, you need to make certain that in addition to reading the textbook, you also use the ExamSuccess software with the past Exam questions. Many of the topics that are covered on the Exam are very large topics and by going through past Exam questions, you can begin to get a feeling for how a topic has been tested in the past and to what depth.

## Section A – Introduction

We start our journey through Part 1 with the topic “*Comply with the IIA’s Attribute Standards.*” Before getting to the actual *Standards*, we first want to have an introduction to the topic of internal auditing. The remaining part of Section A deals with complying with the IIA’s *Standards*. This section will account for 15 - 25% of the Part 1 Exam. All of the topics in this section are covered at a **proficiency level**, which means that you need to know not only the terminology and fundamentals of the topic areas, but also be able to apply the concepts to a given situation.

### The Development of Internal Auditing

The concept of auditing is nothing new and records show that even the earliest of civilizations (e.g., Mesopotamian, Egyptian, Chinese, and Persian) had some form of auditing as far back as 5,000 years ago. Even these early civilizations realized the importance of being able to verify what they had, particularly when it came to verifying the amount of grain they had on hand, because it was primarily through the control of food supplies that they remained in power. As the saying goes “a hungry population is a restless population.” It was at about this time that the concept of internal control took hold. For example “the Egyptians required the actual witnessing of grain being brought to the granaries and demanded that receipts of grain be certified.”<sup>a</sup>

But, it really wasn’t until during the Industrial Revolution period that auditing began as we know it today. During this period, accountants were used to check and verify financial information. To do this, they had to scrutinize written records and compare the book entries with documentary evidence. This is what we generally think of as auditing.

For the most part, it was only in the 1920’s that companies started to publish their audited financial statements. This was primarily done for the benefit of the bankers who wanted some assurance about the validity of the balance sheets. The concept of internal audit was started by the railroads because railroad executives needed to have some assurance that their stationmasters across the country were properly handling receipts. They felt that the work done by the external auditors did not adequately address this issue. Hence, internal auditing became the function that did this for the railroads.

### Difference between External and Internal Auditors

Whereas external auditors were primarily interested in the audit of financial statements, internal auditors were needed to appraise overall operations. From this concept arose The Institute of Internal Auditing (IIA) in 1941. The founders of IIA were really looking to achieve a separate identity from external auditors. They wanted a profession that was concerned with providing independent review of all the entity’s operations, not just a verification of its financial affairs. The primary differences between the internal and external auditor are:

Internal Auditor	External Auditor
<ul style="list-style-type: none"> <li>• Is an organization’s employee.</li> <li>• Serves the needs of the organization.</li> <li>• Focuses on future events by evaluating controls designed to assure the accomplishment of entity goals and objectives.</li> <li>• Is independent of the activities audited but is ready to respond to the needs and desires of all elements of management.</li> </ul>	<ul style="list-style-type: none"> <li>• Is an independent contractor.</li> <li>• Serves third parties who need reliable financial information.</li> <li>• Focuses on the accuracy and understandability of historical events as expressed in financial statements.</li> <li>• Is independent of management and the board of directors both in fact and in mental attitude.</li> </ul>

<sup>a</sup> Sawyer’s *Internal Auditing*, 5<sup>th</sup> edition, pg. 4.

<ul style="list-style-type: none"> <li>• Is directly concerned with the prevention of fraud in any form or extent in any activity reviewed.</li> <li>• Reviews activities continually.</li> </ul>	<ul style="list-style-type: none"> <li>• Is incidentally concerned with the prevention and detection of fraud in general, but is directly concerned when financial statements may be materially affected.</li> <li>• Reviews records supporting financial statements periodically – usually once a year.</li> </ul>
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Source: Sawyer's, 5<sup>th</sup> edition, pg. 7-8

## The Definition of Internal Auditing

Internal auditing has undergone major changes in the past few decades and has come to include areas of specific expertise, and is used outside of financial and accounting matters. This growth of the role and expectations of internal auditors led to the development of internal auditing as a profession. The Institute of Internal Auditors (IIA), the U.S. professional organization of internal auditors, has defined internal auditing as:

“An independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.”

In January 2004, the IIA modified and expanded its definition of the internal audit activity to include the following additional activities and services:<sup>b</sup>

- **Internal audit activities** are performed in diverse legal and cultural environments, within organizations that vary in purpose, size, complexity, and structure, and by persons within or outside the organization. While differences may affect the practice of internal auditing in each environment, compliance with the *International Standards for the Professional Practice of Internal Auditing (Standards)* is essential if the responsibilities of internal auditors are to be met. If internal auditors are prohibited by laws or regulations from complying with certain parts of the *Standards*, they should comply with all other parts of the *Standards* and make appropriate disclosures.
- **Assurance services** involve the internal auditor’s objective assessment of evidence to provide an independent opinion or conclusions regarding a process, system or other subject matter. The internal auditor determines the nature and scope of the assurance engagement. There are generally three parties involved in assurance services: (1) the person or group directly involved with the process, system or other subject matter – the process owner, (2) the person or group making the assessment – the internal auditor, and (3) the person or group using the assessment – the user.
- **Consulting services** are advisory in nature, and are generally performed at the specific request of an engagement client. The nature and scope of the consulting engagement are subject to agreement with the engagement client. Consulting services generally involve two parties: (1) the person or group offering the advice – the internal auditor, and (2) the person or group seeking and receiving the advice – the engagement client. When performing consulting services the internal auditor should maintain objectivity and not assume management responsibility.

<sup>b</sup> IIA website “International Standards for the Professional Practice of Internal Auditing.”

The founding of the IIA contributed to the professionalism of internal auditing. The IIA articles of incorporation list the following objectives:

- To cultivate, promote, and disseminate knowledge and information concerning internal auditing and subjects related thereto;
- To establish and maintain high standards of integrity, honor, and character among internal auditors;
- To furnish information regarding internal auditing and the practice and methods thereof to its members, to other persons interested therein, and to the general public;
- To cause the publication of articles relating to internal auditing and practices and methods thereof;
- To establish and maintain a library and reading rooms, meeting rooms, and social rooms for the use of its members;
- To promote social intercourse among its members;
- To provide internal auditing practitioners, executive management, boards of directors and audit committees with standards, guidance, and information on internal auditing best practices; and
- To do any and all things that shall be lawful and appropriate in furtherance of any of the purposes hereinbefore expressed.

The IIA continuously promotes the internal auditing profession by:

- Adopting a **common body of knowledge (CBOK)** that identifies related disciplines and competencies that internal auditors should develop and maintain within each discipline.
- Promoting the **Professional Practices Framework**, which includes the *Standards*, *Practice Advisories*, *Code of Ethics*, and *Development & Practices Aids*.
- Publishing the **technical journal**, *The Internal Auditor*, which is available for IIA members.
- Offering a **certification program** (CIA), which requires an examination as a prerequisite. The CIA is a globally accepted certification that is designated specifically for internal auditors.
- Administrating the **Continuing Professional Education** (CPE) program, which is required for CIAs to maintain their certification.

## Professional Practices Framework

By definition, any profession needs to hold its members to a high and consistent level of behavior. The profession of internal auditing is no different. The IIA and other related organizations issue various pronouncements to help establish the standards to which members are held and expected to follow. Listed below are these organizations and the names or types of pronouncements they issue.

- The **Internal Auditing Standards Board (IASB)** is charged by the IIA to develop professional standards for internal auditors.
- The **International Ethics Committee** maintains the Code of Ethics and also investigates any complaints against members of the IIA or CIAs.
- The **Board of Regents** establishes the requirements to become a CIA and also the CPE requirements for CIAs.
- The **Professional Issues Committee** reviews and releases the **Practice Advisories**. Practice Advisories are **not mandatory**, but they are viewed by the IIA as best practices.
- The **Executive Committee** approves the administrative directives that are submitted by the appropriate committees.
- **Administrative Directives** specify the processes and procedures that must be followed by the IIA and IASB in regards to the administration of the *Standards*, and the related pronouncements.

These documents are not presented now, but are covered in the sections of the Exam that are more specific to them.

## IIA Professional Standards

The *Standards* are the criteria by which internal auditors should perform their duties in an organization. In addition, the *Standards* are intended to represent the best practices of internal auditing, and the criteria that are applicable to all types of internal auditing departments.

The professional *Standards* have the **following four purposes**:

- 1) Delineate (outline) basic principles that represent the practice of internal auditing, as it should be.
- 2) Provide a framework for performing and promoting a broad range of value-added internal audit activities.
- 3) Establish the basis for the evaluation of internal audit performance.
- 4) Foster (support) improved organizational processes and operations.

The professional *Standards* consist of **Attribute Standards, Performance Standards** and **Implementation Standards**.

**Attribute Standards (1000 – 1300)** are concerned with the characteristics of the organization and the parties who will be performing the auditing activities. The primary components of the **Attribute Standards** are:

- 1) **Purpose, Authority, and Responsibility (1000)** – The purpose, authority, and responsibility of the internal audit activity (IAA) should be formally defined in the internal audit charter, consistent with the *Standards*, and approved by the board.
- 2) **Independence and Objectivity (1100)** – The internal audit activity must be independent, and the internal auditors must be objective in performing their work.
- 3) **Proficiency and Due Professional Care (1200)** – Engagement must be performed with proficiency and due professional care.
- 4) **Quality Assurance and Improvement Program (1300)** – The Chief Audit Executive (the head of the IAA, and abbreviated CAE) must develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity and continuously monitors its effectiveness. This program includes periodic internal and external quality assessments and ongoing internal monitoring. Each part of the program must be designed to help the internal auditing activity add value and improve the organization's operations, and provide assurance that the internal audit activity is in conformity with the **Definition of Internal Auditing**, the **Standards** and the **Code of Ethics**.

**Performance Standards (2000 – 2600)** describe the internal audit activities and criteria against which the performance of these services can be evaluated. The primary components of the **Performance Standards** are:

- 1) **Managing the Internal Audit Activity (2000)** – The CAE must effectively manage the internal audit activity to ensure that it adds value to the organization.
- 2) **Nature of Work (2100)** – The internal audit activity must evaluate and contribute to the improvement of risk management, control, and governance processes using a systematic and disciplined approach.
- 3) **Engagement Planning (2200)** – Internal auditors must develop and record a plan for each engagement, including the scope objectives, timing and resource allocations.
- 4) **Performing the Engagement (2300)** – Internal auditors must identify, analyze, evaluate, and record sufficient information to achieve the engagement’s objectives.
- 5) **Communicating Results (2400)** – Internal auditors must communicate the engagement results.
- 6) **Monitoring Progress (2500)** – The CAE must establish and maintain a system to monitor the disposition of results communicated to management.
- 7) **Resolution of Management’s Acceptance of Risks (2600)** – When the CAE believes that senior management has accepted a level of residual risk that may be unacceptable to the organization, the CAE must discuss the matter with senior management. If the decision regarding residual risk is not resolved, the CAE and senior management must report the matter to the board for resolution.

**Implementation Standards** apply to the specific types of engagements - assurance (A) or consulting (C). For example, Standard 1000 (Purpose, Authority, and Responsibility) consists of implementation standards 1000.A1 or 1000.C1.

The *Standards* are part of the **Professional Practices Framework (PPF)** that was approved by the IIA board in June 1999, and subsequently updated in October 2008 and renamed to the **International Professional Practices Framework (IPPF)**. The *Standards* were last revised in October 2010.

The purpose of the IPPF is to interpret the *Standards* so that internal auditors can more readily use them. The IPPF includes the Definition of Internal Auditing, the Code of Ethics, the *Standards*, and other guidelines. Guidelines regarding how the *Standards* might be applied are included in **Practice Advisories** that are issued by the Professional Issues Committee.

**Practice Advisories** represent the best practices endorsed by The IIA as a means of applying the Definition of Internal Auditing, the Code of Ethics, and the *Standards*. They are usually optional and do not represent all the considerations that may be necessary when applying them, but are simply the recommended set of items that should be addressed or followed. The Practice Advisories were last updated in December 2011.

The Practice Advisories will be identified with the letters PA and then the number. For example, a Practice Advisory for *Standard 1000* would be PA 1000-1, while a Practice Advisory of *Standard 1000.A1* would be PA 1000.A1-1. You do not need to memorize the number of the individual PAs; we have simply provided them for completeness and as a resource if you would like to find the complete PA.

Note: There are a number of different Practice Advisories that are relevant to the topics covered on this Exam. We believe that you do not need to worry about reading the text of the Practice Advisories, but simply that you need to be aware of the general ideas and concepts that they include. When a Practice Advisory is relevant, we will address that Practice Advisory in the materials with a summary, or listing the actual Practice Advisory. The determination of what is relevant has been made using past Exam questions and the current status of a topic in practice today. This approach is more than sufficient for the level of knowledge that is expected to be covered on the Exam and eliminates excessive reading and memorization on your part.

## Comply with the IIA's Attribute Standards

### Purpose, Authority and Responsibility (Standard 1000)

According to the *Standards*, "the purpose, authority, and responsibility of the internal audit activity (IAA) must be formally defined in an internal audit charter, consistent with the Definition of Internal Auditing, the Code of Ethics, and the *Standards*. The chief audit executive must periodically review the internal audit charter and present it to senior management and the board for approval. "

Note: The term "board" generally includes the board of directors, the audit committee, board of governors or trustees of a nonprofit organization, or any other designated governing body in the organization.

In addition to the development within the profession, internal auditing has grown because of the general expectation for public companies to have an internal audit activity and an audit committee composed of non-management directors.

The internal audit activity should encompass every part of an organization's operations, and to this end it must have unlimited access to the company's personnel, records and physical properties.

A company's management, and the board of directors, is responsible for the organization's internal control. Internal auditors are utilized to monitor the performance of the organization's internal control systems. Thus, internal auditing has developed in order to **assist management** in carrying out its **monitoring responsibilities effectively and efficiently**. It is through this assistance that management can carry out their day-to-day functions more effectively and more efficiently.

The objective of internal audit is to promote **effective control at a reasonable cost**.

The internal auditors' responsibilities with respect to the internal control system include:

- Testing individuals' compliance with controls to determine whether policies and procedures established by management are being followed, i.e., the quality of performance in carrying out assigned responsibilities.
- Evaluation of the adequacy and effectiveness of the control system in a systematic and thorough manner.
- Examination and evaluation of the reliability and integrity of financial and operating information and the means used to identify, measure, classify and report the information.
- Reviewing systems that impact operations and reports to determine whether the organization is in compliance with policies, plans, procedures, and regulations.
- Examination and evaluation of the effective and efficient use of an entity's resources.
- Reviewing the means used to safeguard assets and verifying the existence of those assets as appropriate.
- Furnishing analyses, appraisals, recommendations, counsel and information concerning activities reviewed to the management of the organization in order to assist them in the effective discharge of their responsibilities.

### Organizational Status of the Internal Audit Activity

For the internal audit department to accomplish its responsibilities, it must have the necessary status within the organization. This means it must have adequate authority and freedom to carry out the activities that need to be accomplished. If the internal audit activity (IAA) does not have the necessary status within the organization, others will not cooperate with the IAA and the effectiveness of their work will be diminished.

In order to have the necessary status, the internal audit function must **report to the board of directors through the audit committee**. Also, the internal auditors need to be supported by both the audit committee and the board in order to make sure that those who are audited cooperate with them. The support of the board and audit committee will demonstrate that the work is viewed as important for the organization. If the board and audit committee do not support the work of the IAA, others in the organization will not support the efforts of the IAA either.

Along with the correct level of organizational status, the internal audit department must have **organizational independence**. This means that the internal audit function must not have any direct relationships with the departments it will be auditing. Reporting directly to the board of directors and also having policies about the assignment of internal auditors to engagements in departments where they previously worked may strengthen this independence.

A lot of the needed status and independence can be achieved by having a properly designed Internal Audit Charter. This is the focus of our next section.

Question 1: From a modern internal auditing perspective, which one of the following statements represents the most important benefit of an internal audit department to management of the company?

- a) Assurance that the organization is complying with legal requirements.
- b) Assurance that fraudulent activities will be detected.
- c) Assurance that there is reasonable control over day-to-day operations.
- d) Assurance that published financial statements are correct.

(CMA Adapted)

Question 2: The primary objective of internal auditing is to:

- a) Find errors and fraud within the company.
- b) Perform the preliminary work of external financial statement audit.
- c) Provide an opinion about the accuracy and completeness of the quarterly financial statements.
- d) Help the employees of the company effectively perform their jobs.

(HOCK)

Question 3: Management has requested the internal auditor to perform an operational audit of the telephone marketing operations of a major division and recommend policies and procedures for improving management control over the operation. The auditor should:

- a) Accept the engagement, but indicate to management that recommending controls would impair audit independence so that management knows that future audits of that area would be impaired.
- b) Accept the audit engagement because independence would not be impaired.
- c) Not accept the engagement because audit departments are presumed to have expertise on accounting controls, not marketing controls.
- d) Not accept the engagement because recommending controls would impair future objectivity of the department regarding this auditee.

(CIA Adapted)

## The Internal Audit Charter

The internal audit charter (hereafter referred to simply as the charter) provides the (IAA) with a formal mandate to do its work. This charter should **be written** (and periodically reviewed) **by** the Chief Audit Executive (CAE), **approved by** senior management and the board or audit committee, and **communicated to** engagement clients. The charter should define the following items in respect to the IAA:

- 1) The **scope** of the services and work to be performed,
- 2) The **objectives** of the internal audit activity<sup>c</sup>,
- 3) The **authority** that the internal audit activity has to **access records, personnel and physical properties** in the organization,
- 4) The **accountability** of the internal audit activity, and
- 5) The **responsibility** of the internal audit activity.

Note: A sample charter from the IIA is detailed at the end of this section.

The IAA should report to an organizational level that is high enough to be effective, and **independent of the functions that will be audited**. This means that ideally the director of the internal audit department (or the Chief Audit Executive) should report to the Chief Executive Officer (CEO), or board of directors. The accounting department, chief accountant or finance director would not normally be a good level to report to. The preferred option of an increasing number of companies is to have the CAE report to an **audit committee, or its equivalent, for any functional and engagement issues**. For **administrative** issues, the CAE should report to the Chief Executive Officer (or a similar position). This subject is explained in detail later on.

Note: The audit committee is a subcommittee of the board of directors, and its role is one that is becoming more and more important and visible in the wake of the numerous and recent accounting scandals. We will discuss the audit committee in more detail in the next section.

**A well-written charter adds to the organizational independence of the IAA** because if the duties, responsibilities, authority and objectives are spelled out clearly, the IAA will not need to rely on involvement of outsiders to perform its jobs. If there is a poorly written charter that does not establish the IAA properly, it will not be perceived as important or valuable to the company, and its effectiveness will be diminished by people who do not think that they need to cooperate with the IAA.

<sup>c</sup> One of the objectives of the internal audit activity is to "assist the organization in maintaining effective controls by evaluating their effectiveness and efficiency and by promoting continuous improvement." Controls are a very important part of the work of the internal auditor, and are covered later in more detail.

Note: Though the charter is a very formal and important document for the internal audit activity, it is not a document that is unchanging. The CAE should review the document at least annually (and more often as circumstances may require) to ensure that it is still relevant and addresses the needs and issues that the organization and the internal audit activity are facing.

Question 4: The authority of the internal audit activity is limited to that granted by:

- a) The board and the financial controller.
- b) Senior management and the *Standards*.
- c) Management and the board.
- d) The audit committee and the Chief Financial Officer.

(CIA Adapted)

Question 5: An organization is in the process of establishing its new internal audit activity. The financial controller has no previous experience with internal auditors. Due to this lack of experience, the financial controller advised the applicants that the CAE would be reporting to the external auditors. However, the new chief audit executive will have free access to the financial controller to report anything important. The financial controller will then convey the CAE's concerns to the board of directors. The IAA will:

- a) Be independent because the CAE has direct access to the board.
- b) Not be independent because the CAE reports to the external auditors.
- c) Not be independent because the financial controller has no internal auditor experience.
- d) Not be independent because the organization did not specify that the applicants must be Certified Internal Auditors.

(CIA Adapted)

## The Audit Committee

The audit committee is normally a subcommittee of the board of directors. **Its members should be independent non-executive directors (NEDs)**. Independent NEDs are board members who do not have a role in the day-to-day running of the company and do not have any financial interest or other relationship (such as providing consulting services) with the company.

The audit committee receives reports and communications from both external auditors and internal auditors, and should promote their views to the board as a whole.

Note: The number of audit committee members is not set and depends on a number of factors (size and complexity of financial reporting requirements or whether a public, private, or nonprofit organization, etc.). The number varies from a minimum of 3 to typically no more than 9 members.

A written charter approved by the board of directors should detail the audit committee's powers, duties and responsibilities. Among these **duties and responsibilities of the audit committee** are:

- To ensure that the external auditors are completely independent of the company and its subsidiaries, and that they are working in the best interests of the shareholders. The audit committee should ensure that the company complies with all laws and regulations applying to it, and that the necessary reports are filed with the authorities.

- To review and discuss with management and the external auditor the effects of changes in accounting standards, and the implications of these proposed changes.
- To ensure that both the external and internal auditors have sufficient resources to carry out their defined roles.
- To act as a mediator between management and auditors when there is a difference of opinion.
- To appoint or replace the external auditor, who shall report directly to the Audit Committee.
- To be directly responsible for the compensation and oversight of the work of the external auditor.

### Other Audit Committee Functions

In addition to the broad duties and responsibilities listed above, the audit committee also has, among others, the following more specific functions:

- Receiving copies of all external and internal audit reports and communications, and management's responses to them,
- Reviewing all financial communications and statements to be publicly issued by the company,
- Reviewing the strategy, activity and work plan of the internal audit activity, ensuring that it has sufficient staff and resources to function as planned,
- Reviewing evaluations of risk management, control and corporate governance reported by auditors,
- Communicating as necessary with the chief executive officer, either inside the meeting, or by other means, and
- Reviewing policies to eliminate illegal and unethical practices.

Question 6: An audit committee should be designed to enhance the independence of both the internal and external auditing functions and to insulate them from undue management pressures. Using this criterion, audit committees should be composed of:

- a) A rotating subcommittee of the board of directors or its equivalent.
- b) Only members from the relevant outside regulatory agencies.
- c) Members from all important constituencies, specifically including representatives from banking, labor, regulatory agencies, shareholders, and officers.
- d) Only external members of the board of directors or its equivalent.

(CIA Adapted)

Question 7: A charter is being drafted for a newly formed internal audit activity. Which of the following best describes the appropriate organizational status that should be incorporated into the charter?

- a) The chief audit executive should report to the chief executive officer but have access to the board of directors.
- b) The chief audit executive should be a member of the audit committee of the board of directors.
- c) The chief audit executive should be a staff officer reporting to the chief financial officer.
- d) The chief audit executive should report to an administrative vice president.

(CIA Adapted)

## Consulting Services

The IIA *Standards* say that internal auditors are able to perform consulting services. However, they are able to do this only if the nature of the consulting services is defined in the IAA charter.

Consulting services are defined in the *Standards* Glossary: “Advisory and related client services, the nature and scope of which are agreed upon with the client and which are intended to add value and improve an organization’s operations. Examples include counsel, advice, facilitation, process design and training.”

The consulting engagements that are undertaken by the IAA may be formal or informal, and they may or may not be connected to an assurance engagement as well. All of this is to say that the consulting engagements may be of any variety. It is the role of the CAE to determine the particular form and function of a consulting engagement. However, in any case when an assurance engagement is better suited for the needs of the company, the IAA should perform an assurance engagement and not some sort of similar consulting engagement.

Note: An **assessment engagement** varies from consulting services in that an assessment is an objective examination of evidence for the purpose of providing an independent assessment on risk management, control or governance processes for the organization. Examples would include financial performance, compliance, systems security, and due diligence.

The IIA’s previously published Practice Advisories (2006) listed 12 principles that were intended to guide internal auditors during the performance of consulting engagements. The Practice Advisories (formerly PA 1000.C1-1) have since been eliminated, but we still believe that the principles can serve as a useful guide for internal auditors. We summarized and condensed the 12 principles below:

- **Value is added by the IAA** when they perform both assurance and consulting services. In fact, the IAA is in a very good position to provide consulting services to the company because of its professional standards and its knowledge of the company and its operations.
- The fact that the IAA is able to provide consulting services (and any other appropriate services) must be **included in the internal audit charter**. Additionally, any rules or standards applicable to the consulting services must also be included in the charter.
- The IAA may also provide other services besides assurance and consulting, i.e., investigating fraud, and due diligence.
- **Consulting services do not impair the objectivity** of either the individual internal auditor or the IAA (objectivity is addressed in more detail later). However, the auditor needs to remember that his or her first duty is as an auditor, and so all actions need to be governed by the applicable internal audit guidelines and standards as applicable. Objectivity is not impaired as long as the internal auditor provides advice and does not take ownership of a specific process.

If an internal audit activity is performing consulting engagements then it is imperative that the company’s internal auditors take extra precautions to determine that senior management and the board understand and agree with the concept, operating guidelines and communications required for performing consulting engagements.

## Independence and Objectivity (*Standard 1100*)

Just as independence is a major issue for external auditors, independence is also an important issue for internal auditors. However, because the company they are auditing directly employs them, it is impossible for internal auditors to be independent in the same manner as external auditors. Therefore, internal auditors use a different term to refer to the way in which they act in the performance of their work. This word is “objective.” **Internal auditors must be objective in their work, and the IAA needs to be independent within the organization.**

Internal auditors are considered to be independent when they are able to perform their work freely and objectively. This means that other individuals or groups within the company are not able to influence or affect the work and the conclusions of the internal auditors.

Independence is achieved largely through the organizational status of the IAA. If the IAA is perceived to be important and reports to the board of directors, they will be more independent because of the support they receive from the highest levels of the organization. If they report to the chief accountant and it is perceived that they do not add value to the organization, or are not viewed as important by the board, the IAA will have less independence and their work will be less useful to the organization.

## Organizational Independence (*Standard 1110*)

A crucial issue of organization independence is for the CAE to have a reporting line in the organization that will allow the IAA to fulfill its tasks. In order to accomplish this, it is vital for the IAA to have the support of senior management and of the board so that they are able to work freely, and without interference.

The ideal reporting situation is for the CAE to report **administratively** to the chief executive officer (CEO) of the organization, and **functionally** to the audit committee, board of directors, or some other appropriate governing authority.

The meaning of functional and administrative reporting is described below.

**Functional Reporting** is the ultimate source of its independence and authority for the IAA. As such, the IIA recommends that the CAE report functionally to the audit committee, board of directors, or other appropriate governing authority. Responsibilities of the governing body include:

- Approving the IAA charter,
- Approving the internal audit risk assessment and related audit plan,
- Receiving communications from the CAE on the results of the IAA or other private meetings with the CAE without management present,
- Approving all decisions regarding the appointment or removal of the CAE, and
- Making appropriate inquiries of management and the CAE to determine whether there are scope or budgetary limitations that impede the ability of the IAA to execute its responsibilities.

**Administrative Reporting** is the reporting relationship within the organization’s management structure that facilitates the day-to-day operations of the IAA. Administrative reporting typically includes:

- Setting the budget for the IAA,
- Having the human resource department administer personnel evaluations and compensation,
- Monitoring internal communications and information flows, and
- Administering the organization’s internal policies and procedures.

The differences in these reporting lines make sense. For example, if an internal audit department needs to buy some office supplies, it’s not going to go to the audit committee to get approval for the expenditures. For these types of issues, it should go to an administrative person, perhaps the Chief Financial Officer (CFO).

## Direct Interaction with the Board (*Standard 1111*)

We mentioned that in order for the IAA to maintain independence the CAE must **report functionally to the audit committee, board of directors, or some other governing authority**. Functional reporting means that the CAE is **communicating** and **interacting directly with the board** and not through another department, or someone else.

Direct interaction with the board occurs when the CAE:

- Regularly attends and participates in board meetings that relate the board's oversight responsibilities for auditing, financial reporting, organizational governance and control, or
- Meets privately with the board, at least annually.

## Individual Objectivity (*Standard 1120*)

In addition to the IAA as a whole remaining objective, individual internal auditors also need to remain objective in their work. This means that they:

- 1) Must be **impartial**,
- 2) Have an **unbiased attitude**, and
- 3) **Avoid conflicts of interest**.

Having objectivity means that the individual will make the conclusion or decision based on the facts at hand, and not be influenced by feelings, emotions, relationships with others, monetary bribes or any other outside influence. The auditor must have an honest belief in his or her work and believe that no compromises were made in respect to the quality of the work.

In order to assist in this process, assignments to jobs should be made so as to minimize potential conflicts of interests. This may be as basic as not having someone involved in an engagement that audits an area where the auditor's good friend works. Also, jobs should be periodically rotated so that no relationships develop between the auditor and the auditee that might impair the judgment of the auditor.

The acceptance of a gift or money from a client will impair the objectivity of the auditor. Even if the auditor maintains objectivity, it will appear to an outside observer that the auditor is not independent. The acceptance of promotional items, such as pens, calendars, or other insignificant items are not perceived to impair professional judgment. If internal auditors are offered gifts or money considered to be material (i.e., more than \$25-\$50) then this fact needs to be immediately reported to the auditor's supervisor.

Note: The internal auditor making recommendations as part of a consulting project does not impair objectivity in respect to a financial audit.

## Impairments to Independence or Objectivity (*Standard 1130*)

There is any number of situations where the internal auditor's independence or objectivity might be impaired. Impairment could be the result of a personal conflict of interest, or the result of a scope limitation, or pressure from management. Any time an auditor believes that independence or objectivity has been impaired, the auditor must disclose the nature of the impairment to the CAE (or appropriate parties).

Note: A "**conflict of interest**" arises when an employee (e.g., a senior manager, sales representative, etc.) enters a relationship that is not in the best interest of the company. This can prejudice an individual's ability to perform his or her duties and responsibilities objectively. A conflict of interest can exist even if no unethical or improper act results. A conflict of interest can give an appearance of impropriety that can undermine confidence in the internal auditor. A **scope limitation** is a restriction on the internal audit activity that precludes it from accomplishing its objectives and plans. A scope limitation might restrict the IAA's access to records, personnel, and properties relevant to the performance of an engagement.

You need to remember that if impairment arises during the engagement, it must be reported immediately to the manager of the engagement so that the situation can be addressed or eliminated.

It's also important to remember that the internal auditor's objectivity is not considered impaired when the auditor recommends standards of control or reviewing procedures before they are implemented. But, objectivity is considered to be impaired if the auditor **designs, installs, or drafts procedures** for, or **operates** such systems.

### Assessing Operations for Which Internal Auditors Were Previously Responsible

Objectivity is assumed to be impaired if an auditor performs an assurance review of any activity over which he or she recently had responsibility. Individuals who are assigned to or transferred to the IAA should not audit areas where they worked until a reasonable period of time has elapsed, usually **at least one year**. If such an assignment were to occur then objectivity is presumed to be impaired and the facts should be clearly stated when communicating the results relating to the area that was audited.

Note: Objectivity is also impaired when auditors are auditing an area for which they will have responsibility **within one year after** the engagement. For example, if an internal auditor knows that he or she will be transferred to an audited activity, such as financial reporting, then he or she should not be auditing this function.

### Internal Audit's Responsibility for Other (Non-audit) Functions

Organizations are constantly under pressure to do more with less. Therefore, it is possible that management could ask an internal auditor to assume responsibility for operations that could be subject to periodic internal auditing assessments.

Practice Advisory 1130.A2-1 (Internal Audit's Responsibility for Other (Non-audit) Functions) makes it clear that internal auditors are not to accept such responsibility, because if they do, then "they are not functioning as an internal auditor." However, it is possible that management **may insist** on such an assignment. If this does happen then the CAE needs to be careful and review the internal audit charter to see whether it contains any specific restrictions regarding the assignment of internal auditors to non-audit functions. If the charter does contain specific language, then disclosure and discussion with the board will be necessary.

If the internal audit activity does accept operational responsibility and the operation is part of the audit plan, the CAE could minimize the impairment to objectivity by using a third party to complete the audit (for example, using an external auditor or third party contractor). In addition, the CAE should confirm that the individuals who have operational responsibility will not participate in any internal audits of the operation.

Question 8: In which of the following situations does an internal auditor potentially lack objectivity?

- a) An internal auditor reviews the procedures for a new electronic data interchange (EDI) connection to a major customer before it is implemented.
- b) A former purchasing assistant performs a review of internal controls over purchasing 4 months after being transferred to the internal auditing department.
- c) An internal auditor recommends standards of control and performance measures for a contract with a service organization for the processing of payroll and employee benefits.
- d) A payroll accounting employee assists an internal auditor in verifying the physical inventory of small motors.

(CIA Adapted)

## Internal Audit Responsibility for Consulting Engagements

For a number of reasons, it is becoming more common for internal auditors to provide consulting services relating to operations for which they had previous responsibilities. It is not forbidden for internal auditors to provide consulting services to areas over which they had previous responsibility, but the auditors must still act in an independent and objective manner.

Note: If internal auditors have potential impairments to independence or objectivity relating to proposed consulting services, disclosure must be made to the engagement client prior to accepting the engagement (*Standard 1130.C2*).

Question 9: Which of the following activities is not presumed to impair the objectivity of an internal auditor?

- I. Recommending standards of control for a new information system application.
  - II. Drafting procedures for running a new computer application to ensure that proper controls are installed.
  - III. Performing reviews of procedures for a new computer application before it is installed.
- a) I only.
  - b) II only.
  - c) III only.
  - d) I and III.

(CIA Adapted)

## Proficiency and Due Professional Care (*Standard 1200*)

The *Standard* states that all “engagements must be performed with **proficiency** and with **due professional care**.” You must be familiar with these terms that we look at individually below.

### Proficiency (*Standard 1210*)

As stated by the IIA, “Internal auditors must possess the knowledge, skills and other competencies needed to perform their individual responsibilities. The internal audit activity collectively must possess or obtain the knowledge, skills, and other competencies needed to perform its responsibilities.” In other words, proficiency means that individuals have the skills necessary to perform their jobs. Regarding performance of engagements, internal auditors need to be **proficient in the application of internal auditing standards, procedures, and techniques**.

Overall, professional proficiency is the responsibility of the CAE, but it’s also a responsibility of each internal auditor as well. The skills that are necessary for an internal auditor to be proficient will depend on his or her work. If a person does a lot of financial statement work, then he or she needs skills related to the appropriate GAAP. However, if someone works in the areas of internal controls, then detailed knowledge of GAAP would probably not be necessary for proficiency.

However, some skills are more general in their necessity. An **understanding of management principles** is required so that an auditor can recognize and evaluate the materiality and significance of deviations from good business practice. This requires an **appreciation** of the basics of accounting, taxation, economics, business law, finance, information technology and statistics.

Note: The words *understanding* and *appreciation* used above indicate the depth of knowledge.

An **understanding** is the ability to apply broad knowledge to situations likely to be encountered, to recognize material deviations and to be able to perform research to arrive at conclusions.

An **appreciation** is the ability to recognize the existence of problems and potential problems and to determine if further work or assistance is required. This does not mean that the person must be able to do the further work, just that the auditor can recognize that it is needed.

**Example:** A Company has a receivable turnover rate of 4 and days in receivables of 90. Industry average is 5 and 72 days. Having an **appreciation** is being aware that it is taking too long to collect on receivables. **Understanding** is being able to figure out the impact on operations, i.e., its impact on the cash cycle, profit and loss, etc. **Proficiency** is being able to figure out what to do about it. In other words, solve the problem.

In addition to technical audit and accounting related skills, internal auditors need to be skilled communicators, including written and oral communications as well as interpersonal relationships. Knowledge that cannot be communicated is useless to the organization. It is the responsibility of the CAE to ascertain appropriate criteria of education and experience for filling internal audit positions, giving thought to the scope of work and level of responsibility. He or she must have confidence that the IAA staff collectively possesses the knowledge and skills necessary to perform their duties.

Question 10: A CAE has reviewed credentials, checked references, and interviewed a candidate for a staff position. The CAE concludes that the candidate has a thorough understanding of internal auditing techniques, accounting, and finance. However, the candidate has limited knowledge of economics and information technology. Which action is most appropriate?

- a) Reject the candidate because of the lack of knowledge required by the *Standards*.
- b) Offer the candidate a position despite lack of knowledge in certain essential areas.
- c) Encourage the candidate to obtain additional training in economics and information technology and then reapply.
- d) Offer the candidate a position if other staff members possess sufficient knowledge in economics and information technology.

(CIA Adapted)

Question 11: A CAE for a large manufacturer is considering revising the internal audit activity's charter with respect to the required minimum educational and experience qualifications. The CAE wants to require all staff auditors to possess specialized training in accounting and a professional auditing certification such as the Certified Internal Auditor, or the Chartered Accountant (CA). One of the disadvantages of imposing this requirement would be:

- a) The policy might negatively affect the internal audit activity's ability to perform quality engagements relating to the organization's financial and accounting systems.
- b) The policy would not promote the professionalism of the internal audit activity.
- c) The policy would prevent the internal audit activity from using outside service providers when it did not have the knowledge, skills and other competencies required in certain engagements.
- d) The policy could limit the range of services that could be performed due to the internal audit activity's narrow expertise and background.

(CIA Adapted)

## Obtaining Services to Support or Complement the Internal Audit Activity

If the internal audit staff does not have the needed skills and competencies to perform an engagement, the CAE must either decline the engagement, or go outside to get those skills. This may be done by using external auditors, specialists or other service providers such as actuaries, appraisers, environmental specialists, fraud investigators, statisticians, lawyers, and so on.

The extent of engagements for which the organizations may use outside service providers is as extensive as the list of types of people whose skills may be needed. It includes, but is not limited to, the following types of engagements:

- Various audit engagements that require specialist knowledge (such as tax questions, foreign languages, or IT),
- Valuations of assets (both tangible and intangible),
- Determination of physical amounts (oil reserves),
- Fraud,
- Interpretations of legal or tax matters, and
- Mergers and acquisitions.

Whenever using an outsider, the CAE needs to make certain that the skills and reputation of the hired person or company have been evaluated. This assessment should be made by the CAE even if the expert is not hired directly by the CAE. It is possible that the CAE will determine that he or she cannot rely on the work of the expert. If this is the case, the CAE needs to communicate this to the board and to the individual that engaged the expert.

In this assessment of the external party, the CAE should consider, among many things, the following:

- The relevant professional certifications of the person,
- Membership in a professional organization,
- Their experience in similar situations,
- Their reputation,
- Their education and training in the area that they will be engaged in, and
- Their knowledge of the business and industry.

The CAE also needs to consider the independence and objectivity of the expert in respect to the engagement. A lack of independence or objectivity may not prevent hiring the expert, but the CAE will want to know if the expert is independent and objective when assessing work and conclusions. The CAE will be particularly interested to know about any financial or other affiliations the expert has with the organization and with its people (e.g., with the board, senior management or others within the organization). The CAE is looking for a level of assurance that the engagement will be done in an impartial and unbiased manner.

Note: Experts that are from the engagement client should almost never be used because of the lack of objectivity of that party in the performance of their work.

If the expert is the external auditor, the CAE will need to be certain that this work that is not part of the financial statement audit, so that it will not impair the external auditor's independence for the financial statement audit.

Any work performed by an outside expert must be reviewed by either the CAE or other internal person with sufficient experience and understanding to review the work. The CAE does not need to be able to perform the technical work of the expert, but should assess whether the work done and conclusions drawn were reasonable, unbiased, and address all of the issues of the engagement.

Question 12: If the internal audit activity does not have the skills to perform a particular task, an outside service provider could be brought in from:

- I. The organization's external audit firm.
  - II. An outside consulting firm.
  - III. The engagement client.
  - IV. A college or university.
- a) I, II.
  - b) II, IV.
  - c) I, II, III.
  - d) I, II, IV.

(CIA Adapted)

Question 13: When an engagement was assigned, management asked the internal auditor to evaluate the appropriateness of using self-insurance to minimize risk to the organization. Given the scope of the engagement requested by management, should the internal auditor engage an actuarial consultant to assist in the engagement if these skills do not exist on staff?

- a) No. The internal audit activity is skilled in assessing controls, and the insurance control concepts are not distinctly different from other control concepts.
- b) No. It is a normal internal auditor function to assess risk; this engagement is therefore not unique.
- c) Yes. An actuary is essential to determine whether the health care costs are reasonable.
- d) Yes. The actuary has skills, not usually found among internal auditors, to identify and quantify self-insurance risks.

(CIA Adapted)

Question 14: Use of outside service providers with expertise in health care benefits is appropriate when the internal audit activity is:

- a) Evaluating the organization's estimate of its liability for postretirement benefits, which include health care benefits.
- b) Comparing the cost of the organization's health care program with other programs offered in the industry.
- c) Training its staff to conduct an audit of health care costs in a major division of the organization.
- d) All of the answers are correct.

(CIA Adapted)

## Due Professional Care (*Standard 1220*)

Due professional care requires that **internal auditors apply the skill and care expected of a reasonably prudent and competent internal auditor**. This standard does not mean that the auditor will never make a mistake and will always perform perfectly, but it does mean that the auditor will do everything that could be expected to achieve that goal.

Internal auditors are not expected to perform a detailed review of every statement or document they receive, but are expected to examine and verify the documents as appropriate given the information contained in them. This means that the more **material** items will be examined in more detail than **immaterial** items.

As part of assessing documents and information, internal auditors should always consider the possibility of intentional errors on the part of others, inefficiencies, waste and conflicts of interest.

To ensure that they are exercising due professional care, internal auditors should:

- Consider the work that will be required to achieve the objectives,
- Understand the complexity, materiality and significance of matters that they will be addressing in the engagement,
- Understand the adequacy and effectiveness of risk management, control and governance processes,
- Assess the probability of significant errors, irregularities, or noncompliance,
- Balance the costs of the work and the benefits of the work, and
- Consider the use of computer-assisted audit tools and other data analysis techniques.

In addition, the internal auditor must exercise due professional care when providing consulting services for a client. For consulting services, the internal auditor should consider the following:

- The needs and expectations of clients, including the nature, timing, and communications of engagement results.
- The relative complexity and extent of work needed to achieve the engagement's objectives (professional skills and resources).
- Cost / benefit analysis of the engagement.

In the quest to exercise due professional care, the internal auditor must be aware that there might be significant risks inherent in the conduct of the audit. Assurance procedures are intended to help the auditor reduce risk in the audit, but the internal auditor must understand that assurance procedures will not guarantee that significant risks will be identified or eliminated.

Question 15: Which of the following statements is true with respect to due professional care?

- a) An internal auditor should perform detailed tests of all transactions before communicating results.
- b) An item should not be mentioned in an engagement communication unless the internal auditor is absolutely certain of the item.
- c) An engagement communication should never be viewed as providing an infallible truth about a subject.
- d) An internal auditor has no responsibility to recommend improvements.

(CIA Adapted)

Question 16: An internal auditor has some suspicion of, but no information about, potential misstatement of financial statements. The internal auditor has failed to exercise due professional care if he or she:

- a) Identified potential ways in which a misstatement could occur and ranked the items for investigation.
- b) Informed the engagement manager of the suspicions and asked for advice on how to proceed.
- c) Did not test for possible misstatements because the engagement work program had already been approved by management.
- d) Expanded the engagement work program, without the engagement client's approval, to address the highest ranked ways in which a misstatement may have occurred.

(CIA Adapted)

Question 17: An internal auditor fails to discover an employee fraud during an assurance engagement. The non-discovery most likely suggests a violation of the *Standards* if it was the result of a:

- a) Failure to perform a detailed review of all transactions in the area.
- b) Determination that any possible fraud in the area would not involve a material amount.
- c) Determination that the cost of extending procedures in the area would exceed the potential benefits.
- d) Presumption that the internal controls in the area were adequate and effective.

(CIA Adapted)

### Continuing Professional Development (*Standard 1230*)

Internal auditors should always be striving to enhance their skills, knowledge and other competencies so that they are better able to successfully complete their internal audit work. As with any profession, internal auditors need continued professional development regardless of whether or not the internal auditor is a holder of a professional certification, such as the CIA. Continuing professional development, also known as Continued Professional Education (CPE), includes:

- Maintaining proficiency through continuing their education, and
- Staying informed about improvements and current developments in the internal audit standards, procedures, and techniques.

Practicing CIAs must complete and report 80 hours of CPE every two years. CPE may be done through professional organizations (such as the IIA), attending training courses, formal education classes, etc.

Note: New CIAs are awarded 80 CPE hours for passing the exam (40 CPE hours are awarded to newly certified CCSA, CGAP, or CFSAs). Half of these CPE hours (40) are for the year in which the exam is passed, and the other 40 hours for the subsequent year. Similarly, CCSAs, CGAPs, and CFSAs receive 20 CPE hours for the year in which they passed the exam and 20 CPE hours for the subsequent year.

## Quality Assurance and Improvement Program (*Standard 1300*)

Another important function of the CAE is to assure the quality of the work performed by the internal audit activity. This can be done through the establishment of a **quality assurance and improvement program (QAIP)**.

This **program** includes **periodic internal** and **external quality assessments** and **ongoing internal monitoring**. Each part of the program is designed to help the internal auditing activity add value and improve the organization's operations and to provide assurance that the internal audit activity is in conformity with the Definition of Internal Auditing and the *Standards* and an evaluation of whether internal auditors apply the *Code of Ethics*. Thus, it is the QAIP that justifies the internal audit activity, but it will be the CAE doing the justifying. Therefore, the IAA is really auditing itself. But, as we will see later, this is only partially true.

### Requirements of the Quality Assurance and Improvement Program (*Standard 1310*)

The CAE will be responsible for the implementation of a quality program, the monitoring of that quality program and the assessment of the quality of the program. The quality program must include both **internal** and **external assessments**.

The function of these internal and external assessments is for the company stakeholders (i.e., top management, audit committee, external auditors) to feel comfortable with the services the IAA is providing to the organization. They're asking the question - *Is the IAA is contributing to the overall success of the organization?* In addition, these assessments can provide a way for the CAE to identify opportunities for improving the operational effectiveness and efficiency of the IAA.

QAIP assessments should include evaluations of:

- Compliance with the Definition of Internal Auditing, the Code of Ethics and the *Standards*, including timely corrective actions to remedy any significant instances of noncompliance.
- Adequacy of the IAA's charter, goals, objectives, policies, and procedures.
- Contribution to the organization's governance, risk management and control processes.
- Compliance with applicable laws, regulations, and other governmental or industry standards.
- Effectiveness of continuous improvement activities and adoption of best practices.
- The extent to which the internal auditing activity adds value and improves the organization's operations.

The results of these assessments will then be provided to various stakeholders of the activity, such as senior management, the board, and external auditors. At least annually, the CAE should report to senior management and the board the results of internal assessments on the efforts and results of the QAIP.

A problem that can often arise when doing quality program assessments is that quality can mean different things to different people. This is particularly true of service operations such as the internal audit activity. For example, the internal audit department may be conforming to the *Standards*, but that doesn't mean it's operating in an effective or efficient manner. To resolve this potential problem, organizations develop **quality circles**.

A quality circle is a group of five to fifteen employees who are intimately familiar with an operation and are brought together to improve quality and productivity. They do this by studying the operation, or problem, and making recommendations. Depending on the operation, they may also have the authority to implement recommendations.

Quality circles frequently use benchmarking as a means to improve quality and productivity. **Benchmarking** is the process of a company using the standards set by other companies as a target or model for its own operations. (This is also called **best practices**.) It is the process of continuously trying to emulate (imitate) the best companies in the world. By striving to meet the standards of the best companies, an organization

may be able to create a **competitive advantage** by achieving a higher standard than its competitors. Benchmarking can use both financial (profit margin) and non-financial (% of defects) measures.

The company that is used as the benchmark does not necessarily need to be in the same industry as the company that is trying to improve. If the function is one that is the same across industries, the best company, no matter what industry, should be used as the benchmark.

Question 18: An example of an internal, non-financial benchmark is:

- a) The labor rate of comparably skilled employees at a major competitor's plant.
- b) The average actual cost per pound of a specific product at the company's most efficient plant becoming the benchmark for the company's other plants.
- c) The company setting a benchmark of \$50,000 for employee training programs at each of the company's plants.
- d) The percentage of customer orders delivered on time at the company's most efficient plant as a benchmark for the company's other plants.

(CIA Adapted)

Question 19: A company with many branch stores has decided to benchmark one of its stores for the purpose of analyzing the accuracy and reliability of branch store financial reporting. Which of the following is the most likely measure to include in a financial benchmark?

- a) High number of suppliers.
- b) High level of employee participation in setting budgets.
- c) High amount of bad-debt write-offs.
- d) High turnover of employees.

(CIA Adapted)

### Internal Assessments (*Standard 1311*)

Internal reviews must be carried out periodically to assure the CAE that subordinates are complying with the *Standards* and other applicable criteria. The internal audit assessment must include an **ongoing review** of performance of the internal audit activity, as well as a **periodic review** of the program through self-assessment or from an independent person within the organization who is familiar with the internal auditing program.

The following detailed information on ongoing and periodic reviews is provided in PA 1311-1 (Internal Assessments).

**Ongoing Reviews** are the conclusions and follow-up actions that should be taken to assure appropriate improvements are implemented. Ongoing reviews may be conducted through:

- Supervision of the internal auditor's work during the course of the audit engagement,
- Checklists and other means to provide assurance that processes adopted by the audit activity are being followed,
- Feedback from audit customers and other stakeholders,
- Analyses of performance metrics (e.g., cycle time and recommendations accepted), and
- Project budgets, timekeeping systems, audit plan completion, cost recoveries, and so forth.

**Periodic Reviews** should be designed to assess compliance with the activity's charter, the Definition of Internal Auditing, the Code of Ethics, and the *Standards*. Periodic internal assessment may:

- Include more in-depth interviews and surveys of stakeholder groups,
- Be performed by members of the IAA (self-assessment),
- Be performed by CIAs, or other competent audit professionals, currently assigned elsewhere in the organization,
- Encompass a combination of self-assessment and preparation of materials subsequently reviewed by CIAs, or other competent audit professionals, from elsewhere in the organization, and
- Include benchmarking of the IAA practices and performance metrics against relevant best practices of the internal audit profession.

The cost of an internal review will be lower than an external review, but the CAE needs to be cautious because the review may not be quite as rigorous because people inside the organization are doing the review.

### **External Assessments (Standard 1312)**

External reviews are an opportunity to provide an independent opinion on the quality of the audit activity to the CAE and other various stakeholders of the activity, such as senior management, the board, and external auditors. It is recommended that a qualified, independent person or team outside the organization conduct these external reviews **at least once every five years**.

If the assessment is done from outside the organization, the benefit is that the assessment is more independent and not as likely to be biased. Of course, this advantage is offset by the higher cost of the assessment, but this is a decision that the CAE will need to make.

Additionally, an external assessment will probably not be able to look at all of the cost benefit analysis that would be necessary to determine if the IAA is, in total, "profitable" to the company. This limitation is because the financial information that would be necessary to make that determination may not be as available to an external assessor as it would be to an internal assessor.

In a review, an external assessor will tend to focus on:

- The adequacy of the internal audit charter,
- The goals, objectives, policies and procedures of the IAA,
- Whether or not the work done by the IAA is in accordance with the charter,
- Whether or not the work done is in conformance with the Definition of Internal Auditing, the Code of Ethics, and the *Standards*,
- The contribution of the IAA to the organization's risk management, governance and internal controls,
- The methods and work programs of the IAA,
- The skills and work performed by the individuals in the IAA, and
- Whether or not the IAA adds value and improves the operations of the organization.

Practice Advisory 1312-1 (External Assessments) lays out two approaches for conducting an external assessment. The **first approach** is to have a **full external assessment conducted by an external assessor**, or **review team**. This is generally what you would think of when talking about an external assessment.

The **second approach** involves the use of an independent assessor or review team to conduct an independent validation of the **internal self-assessment** and a report completed by the internal audit activity. Ideally, we would prefer to have a full external review, but there may be cases where this is just not practical. Practice Advisory 1312-2 (External Assessments: Self-assessment with Independent Validation) gives some examples where a full external review might not be appropriate or necessary. For example, the IAA may:

- Be in an business or industry that is subjected to strict regulations and supervision,
- Be otherwise subject to extensive external oversight and direction relating to governance and internal controls,
- Have been recently subjected to an external review(s), or consulting services in which there was extensive benchmarking with best practices, or
- In the judgment of the CAE, the benefits of self-assessment for staff development and the strength of the internal quality assurance and improvement program currently outweigh the benefits of a quality assessment by an external term.

After the self-assessment has been completed under the direction of the CAE, a draft report, similar to that for an external assessment, is prepared, which includes the CAE's judgment on the conformance with the *Standards*.

The external assessor then performs sufficient tests of the self-assessment to validate the results and express an opinion on the level of the activity's conformance with the Definition of Internal Auditing, the Code of Ethics, and the *Standards*.

As part of the independent validation, the external assessor will:

- Review the draft report and attempt to reconcile unresolved issues (if any).
- If in agreement with the evaluation, the external assessor might include additional wording to the report (if needed), concurring with the self-assessment process and opinion and – to the extent deemed necessary – in the report's findings, conclusions, and recommendations.
- If not in agreement with the evaluation, the external assessor would add dissenting wording to the report, specifying the points of disagreement with it and – to the extent appropriate – with the significant findings, conclusions, recommendations, and opinions in the reports.
- Alternatively, the external assessor may prepare a separate independent validation report – concurring or expressing disagreement as outlined above – to accompany the report of the self-assessment.

The final report of the self-assessment, validated by an external assessor, will be signed by the self-assessment team and external assessor and issued by the CAE to senior management and the board.

### **Reporting on the Quality Assurance and Improvement Program (*Standard 1320*)**

The function of the Quality Assurance and Improvement Program (QAIP) is to provide an analysis of the work of the IAA and make recommendations for improvement, if appropriate. Since the CAE is in charge of the IAA, then it is the CAE who has the most to be gained by the information contained in the assessment reports. Therefore, it is the CAE's responsibility to communicate the results of the QAIP to senior management and the board. This means that it the CAE's responsibility is to develop and maintain the QAIP for both external and internal assessments. We discuss specific report functions below.

**External assessments:** Upon completion of the external assessment, the assessor will send a formal communication to senior management and the board that discusses the findings of the assessment. However, preliminary results of the assessment should be discussed with the CAE. The final results are communicated to the CAE with copies sent directly to senior management and the board. Based on the report, the CAE will then need to communicate specific planned actions to be taken concerning significant issues.

**Internal assessments:** Internal assessments are carried out to assure the CAE that subordinates are complying with the *Standards* and other applicable criteria. It is the CAE's responsibility to ensure that, at least annually, results of the internal assessments, necessary action plans and their successful implementation are reported to senior management and the board.

Note: In a case where the CAE is grossly incompetent or has been strongly criticized in the report, a copy will also be provided to the audit committee or the board. In most cases, however, the report is provided to the CAE.

When the board is not directly copied on the report, the CAE should forward the report to the board along with the CAE's opinion as to whether or not the activities of the IAA are in compliance with the appropriate standards. If the CAE believes that the activities are in compliance with the standards, they must be able to demonstrate this compliance.

Similarly, the follow-up on the contents of the report (especially when it is an external assessment) is the responsibility of the CAE.

### Use of "Conforms with the *International Standards for the Professional Practice of Internal Auditing*" (Standard 1321)

The chief audit executive (CAE) wants to be able to state that the internal audit activity conforms to the *International Standards for the Professional Practice of Internal Auditing*. However, the CAE may use this statement only if assessments provide information that the IAA is in compliance. Providing information about compliance requires an external assessment at least once during each five-year period, along with periodic internal assessments. Both of these assessments have to conclude that the IAA is in conformance with the Definition of Internal Auditing, the Code of Ethics, and the *Standards*. It is expected that before any use of the conformance statement, all instances of non-conformance will have been rectified.

Note: There are a few phrases that may be used to communicate the compliance with the standards. These are: "in compliance with the *Standards*," or "in conformity to the *Standards*," or "in accordance with the *Standards*."

### Disclosure of Noncompliance (Standard 1322)

There may be cases in which full compliance is not possible due to the lack of skilled and qualified people, or for any other reason. In the incidences when noncompliance impacts the overall scope of the operation, a "**Disclosure of Noncompliance**" statement should be made to senior management and the board.

Question 20: The chief audit executive should develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity and continuously monitors its effectiveness. All of the following are included in a quality program except:

- a) Annual appraisals of individual internal auditors' performance.
- b) Periodic internal assessment.
- c) Supervision.
- d) Periodic external assessments.

(CIA Adapted)

Question 21: Formal internal quality assessments of the internal audit activity primarily serve the needs of:

- a) The board of directors.
- b) The internal audit activity's staff.
- c) The chief audit executive.
- d) Senior management.

(CIA Adapted)

Question 22: As a part of a quality program, internal assessment teams most likely will examine which of the following to evaluate the quality of engagement planning and documentation for individual engagements?

- a) Project assignment documentation.
- b) Weekly status reports.
- c) The long-range engagement work schedule.
- d) Written engagement work programs.

(CIA Adapted)

Question 23: Which of the following is the best means of aiding an internal audit activity in determining whether its goals are being met?

- a) Having the board periodically review the quality of the internal audit activity's work.
- b) Developing measurement criteria to accompany its goals.
- c) Scheduling an external assessment every 3 years.
- d) Having external auditors review and evaluate the work of the internal audit activity.

(CIA Adapted)

## The IIA's Code of Ethics

The accounting scandals that have invaded the U.S. business community the past few years have put even greater importance on ethics and ethical behavior in the business community. Business ethics is driven by management culture and has a direct impact on investor confidence. Good business ethics promotes good business practices, thereby, having a positive impact on the bottom line.

The purpose of the internal auditing activity is to be an independent, objective assurance and consulting activity designed to add value and improve operations. The IIA's Code of Ethics is intended to be the ethical guide of conduct for internal auditors. You need to be familiar with the different ethics and how they relate to different circumstances.

### Applicability and Enforcement

The following information was downloaded from the IIA website ([www.theiia.org](http://www.theiia.org)).

The IIA's Code of Ethics applies to both individuals and entities that provide internal auditing services. For Institute members and recipients of or candidates for IIA professional certifications, breaches of the Code of Ethics will be evaluated and administered according to The Institute's Bylaws and Administrative Guidelines. The fact that a particular conduct is not mentioned in the Rules of Conduct does not prevent it from being unacceptable or discreditable, and therefore, the member, certification holder, or candidate can be liable for disciplinary action.

Note: Items in *italics* on the next page have been added for further explanation.

There are essentially **two components** of the Institute's Code of Ethics: **Principles** and **Rules of Conduct**.

- **Principles** that are relevant to the profession and practice of internal auditing; and
- **Rules of Conduct** that describes behavior norms expected of internal auditors. The rules are an aid for the internal auditor to interpret the Principles into practical application and are intended to guide the ethical conduct of internal auditors.

### Principles

Internal auditors are expected to apply and uphold the following principles:

#### 1) Integrity

The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgment.

#### 2) Objectivity

Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgments.

#### 3) Confidentiality

Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.

#### 4) Competency

Internal auditors apply the knowledge, skills, and experience needed in the performance of internal auditing services.

## Rules of Conduct

### 1) Integrity

Internal auditors:

- 1.1. Shall perform their work with honesty, diligence, and responsibility. *[In other words, the auditor does the right thing.]*
- 1.2. Shall observe the law and make disclosures expected by the law and the profession.
- 1.3. Shall not knowingly be a party to any illegal activity, or engage in acts that are discreditable to the profession of internal auditing or to the organization.
- 1.4. Shall respect and contribute to the legitimate and ethical objectives of the organization.

### 2) Objectivity

Internal auditors:

- 2.1. Shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interests of the organization.
- 2.2. Shall not accept anything that may impair or be presumed to impair their professional judgment. *[For example, a material gift (use of beach house) is considered to impair objectivity.]*
- 2.3. Shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review. *[For example, there may be some items that were capitalized instead of expensed. This fact needs to be disclosed to management and the Audit Committee.]*

### 3) Confidentiality

Internal auditors:

- 3.1. Shall be prudent in the use and protection of information acquired in the course of their duties.
- 3.2. Shall not use information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organization.

### 4) Competency

Internal auditors:

- 4.1. Shall engage only in those services for which they have the necessary knowledge, skills, and experience.
- 4.2. Shall perform internal auditing services in accordance with the *International Standards for the Professional Practice of Internal Auditing*.
- 4.3. Shall continually improve their proficiency and the effectiveness and quality of their services.

Question 24: During the course of an engagement, an internal auditor makes a preliminary determination that a major division has been inappropriately capitalizing research and development expense. The engagement is not yet completed, and the auditor has not documented the problem or determined that it really is a problem. However, the auditor is informed that the CAE has received the following from the president of the organization:

"The controller of Division B informs me that you have discovered a questionable account classification dealing with research and development expense. We are aware of the issue. You are directed to discontinue any further investigation of this matter until informed by me to proceed. Under the confidentiality standard of your profession, I also direct you not to communicate with the outside auditors regarding this issue." Which of the following is an appropriate action for the CAE to take regarding the questionable item?

- a) Immediately report the communication to The Institute of Internal Auditors and ask for an ethical interpretation and guidance.
- b) Inform the president that this scope limitation will need to be reported to the board.
- c) Continue to investigate the area until all the facts are determined and document all the relevant facts in the engagement records.
- d) Immediately notify the external auditors of the problem to avoid aiding and abetting a potential crime by the organization.

(CIA Adapted)

## Sample Internal Audit Activity Charter

The following sample charter was copied directly from the IIA website ([www.theiia.org](http://www.theiia.org)).

### **Mission and Scope of Work**

The mission of the internal audit department is to provide independent, objective assurance and consulting services designed to add value and improve the organization's operations. It helps the organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

The scope of work of the internal audit department is to determine whether the organization's network of risk management, control, and governance processes, as designed and represented by management, is adequate and functioning in a manner to ensure:

- Risks are appropriately identified and managed.
- Interaction with the various governance groups occurs as needed.
- Significant financial, managerial, and operating information is accurate, reliable, and timely.
- Employees' actions are in compliance with policies, standards, procedures, and applicable laws and regulations.
- Resources are acquired economically, used efficiently, and adequately protected.
- Programs, plans, and objectives are achieved.
- Quality and continuous improvement are fostered in the organization's control process.
- Significant legislative or regulatory issues impacting the organization are recognized and addressed properly.

Opportunities for improving management control, profitability, and the organization's image may be identified during audits. They will be communicated to the appropriate level of management.

### **Accountability**

The chief audit executive (CAE), in the discharge of his or her duties, shall be accountable to management and the audit committee to:

- Provide annually an assessment on the adequacy and effectiveness of the organization's processes for controlling its activities and managing its risks in the areas set forth under the mission and scope of work.
- Report significant issues related to the processes for controlling the activities of the organization and its affiliates, including potential improvements to those processes, and provide information concerning such issues through resolution.
- Periodically provide information on the status and results of the annual audit plan and the sufficiency of department resources.
- Coordinate with and provide oversight of other control and monitoring functions (risk management, compliance, security, legal, ethics, environmental, external audit).

### **Independence**

To provide for the independence of the internal auditing department, its personnel report to the CAE, who reports functionally to the audit committee and administratively to the chief executive officer in a manner outlined in the above section on Accountability. It will include as part of its reports to the audit committee a regular report on internal audit personnel.

**Responsibility**

The CAE and staff of the internal audit department have responsibility to:

- Develop a flexible annual audit plan using an appropriate risk-based methodology, including any risks or control concerns identified by management, and submit that plan to the audit committee for review and approval as well as periodic updates.
- Implement the annual audit plan, as approved, including as appropriate any special tasks or projects requested by management and the audit committee.
- Maintain a professional audit staff with sufficient knowledge, skills, experience, and professional certifications to meet the requirements of this Charter.
- Establish a quality assurance program by which the CAE assures the operation of internal auditing activities.
- Perform consulting services, beyond internal auditing’s assurance services, to assist management in meeting its objectives. Examples may include facilitation, process design, training, and advisory services.
- Evaluate and assess significant merging/consolidating functions and new or changing services, processes, operations, and control processes coincident with their development, implementation, and/or expansion.
- Issue periodic reports to the audit committee and management summarizing results of audit activities.
- Keep the audit committee informed of emerging trends and successful practices in internal auditing.
- Provide a list of significant measurement goals and results to the audit committee.
- Assist in the investigation of significant suspected fraudulent activities within the organization and notify management and the audit committee of the results.
- Consider the scope of work of the external auditors and regulators, as appropriate, for the purpose of providing optimal audit coverage to the organization at a reasonable overall cost.

**Authority**

The CAE and staff of the internal audit department are authorized to:

- Have unrestricted access to all functions, records, property, and personnel.
- Have full and free access to the audit committee.
- Allocate resources, set frequencies, select subjects, determine scopes of work, and apply the techniques required to accomplish audit objectives.
- Obtain the necessary assistance of personnel in units of the organization where they perform audits, as well as other specialized services from within or outside the organization.

The CAE and staff of the internal audit department are not authorized to:

- Perform any operational duties for the organization or its affiliates.
- Initiate or approve accounting transactions external to the internal auditing department.
- Direct the activities of any organization employee not employed by the internal auditing department, except to the extent such employees have been appropriately assigned to auditing teams or to otherwise assist the internal auditors.

**Standards of Audit Practice**

The internal audit department will meet or exceed the *Standards for the Professional Practice of Internal Auditing* of The Institute of Internal Auditors.

Chief Audit Executive \_\_\_\_\_

Chief Executive Officer \_\_\_\_\_

Audit Committee Chairman \_\_\_\_\_

Dated \_\_\_\_\_

## Answers to Questions

**1 c** – This is the most important benefit the internal auditor provides – to ensure that management has control over its day-to-day operations.

**2 d** – If employees can more effectively perform their jobs, then there is a greater chance that the goals and objectives of the company will be realized.

**3 b** – Independence would not be impaired since the internal auditor would only recommend policies and procedures, not carry them out. Objectivity is considered to be impaired if the internal auditor designs, installs, drafts procedures for, or operates such systems.

**4 c** – Since the IAA is established by the board and management, the only authority that the IAA has is what is granted by the board and management.

**5 b** – Because the CAE reports to the external auditors, there is nobody that the CAE reports to in the organization who is able to promote the independence of the IAA. Choice (a) is not enough because the CAE needs to have a better relationship within the organization than simply reporting items of importance to the controller. Choices (c) and (d) are incorrect because the certification of the internal auditors or the internal audit experience of the CAE do not impact the independence of the IAA.

**6 d** – By definition, the audit committee should be made up of external members of the board of directors.

**7 a** – The CAE should report to the CEO. The CAE should also have access to the board of directors.

**8 b** – Internal auditors should not be involved in engagements related to areas for which they were responsible for at least 12 months after the responsibility ended. Even if they may be able to act objectively, the appearance is that they are not.

**9 d** – It is acceptable for the internal auditor to be involved in recommending standards of control and performing reviews of procedures before a system is purchased. However, the internal auditor should not draft procedures for testing that controls are installed. This puts the internal auditor in a position to say that the tests are installed when they are not, and then going back and taking advantage of the poorly designed system. The internal auditor can test to see that the controls are installed, but should not establish the procedures for running that application.

**10 d** – It is not critical for every member of the IAA to be an expert or have knowledge of every possible area that might be useful in an engagement. As long as these skills already exist in the IAA, then this individual may be hired without any issue.

**11 d** – Many different sets of skills are required in an IAA in order to be able to provide a wide variety of services. If all of the members of the IAA need to be professional accountants, it is very likely that other non-accounting skills (economics, statistics, for example) might not be within the IAA. Having such a requirement would not preclude hiring outside experts and it would certainly lead to a very strong, very professional audit team in the areas of financial and accounting systems.

**12 d** – The outside experts should never come from the client of the engagement. That individual will not have the required independence or objectivity. All other listed sources are good sources for external experts.

**13 d** – This is a situation where if the needed skills are not within the IAA, an outside expert may be used. Choice (c) is incorrect because the internal auditor is likely able to determine if the costs are reasonable.

**14 d** – Outside service providers may be used whenever a skill is required that is not already within the IAA. In all of these cases listed, it is very possible that the needed skills are not in the IAA. Therefore, it is appropriate to engage an outside expert in these situations.

**15 c** – Due professional care does not imply that the auditor is perfect. Therefore, no audit communication should be viewed as absolutely perfect and without chance of error. Choice (a) is incorrect because the internal auditor should not test every transaction. Choice (b) is incorrect because the auditor will from time to time need to communicate something about which they are not 100% certain. Choice (d) is incorrect because the internal auditor should recommend improvements.

**16 c** – Due professional care would require further testing of any potential financial statement misstatements, even if they are outside the scope of the existing engagement.

**17 d** – If the fraud occurred because the internal auditor assumed that the controls were adequate and effective, but did not test them, this would be a violation of the standards. In this case, due professional care had not been exercised.

**18 d** – This is an internal benchmark because it is comparing different plants within the company, and it is non-financial because it is measuring the number of on-time deliveries. The other choices are either external, financial or both.

**19 c** – Whereas the last question asked for a non-financial benchmark, this question asks for a financial benchmark. Of the choices, only the bad debts is a financial item.

**20 a** – Though this would appear to be a function of quality, the annual evaluation of the staff is an HR function. The other choices are all specifically listed as part of a quality program.

**21 c** – Though the assessments benefit everyone in the organization, it is the CAE who is the primary recipient of the benefit because the CAE is responsible for the performance of the IAA.

**22 d** – The best way to assess the quality of engagement planning and documentation is to look at the written work programs. The other choices do not give a chance to assess the documentation.

**23 b** – In order to determine if goals have been met, the goals need to be established and there needs to be a way to measure the achievement of that goal. Without a measurement of some sort, it is difficult to determine if the goal has been achieved.

**24 b** – This is a scope limitation and will need to be reported to the board. The board will then make the final decision regarding the appropriate action. The IIA and external auditors are not involved and do not need to be informed, and additional work should not be done until it is known how the engagement will proceed.