2018 Edition

CIA

Preparatory Program

Part 1

Sample

Internal Audit Basics

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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.

Exam Introduction

The CIA Part 1 exam, **Internal Audit Basics**, is 150 minutes (2 hours and 30 minutes) long and consists of 125 multiple-choice questions. This exam tests aspects of mandatory guidance from the *International Professional Practices Framework* (IPPF), internal control and risk concepts, and tools and techniques for conducting internal audit engagements.

There are three Sections in the Part 1 Exam syllabus. The percentages of the exam that these Sections represent are:

- **Section I**: Mandatory Guidance (35–45%)
- **Section II**: Internal Control and Risk (25–35%)
- **Section III**: Conducting Internal Audit Engagements—Audit Tools and Techniques (28–38%)

Additionally, the IIA syllabus gives guidance for the depth to which you must know the topics. There are two levels:

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

Sections I and III are tested at the Proficiency Level and Section II is tested at the Awareness Level.

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 questions from past exams. Many of the exam topics are very wide-ranging, and by going through past exam questions you can get a feeling for how a topic has been tested in the past and to what depth.

Box Styles Used in This Book

The following box styles used throughout this book indicate material quoted from various IIA sources. Minor changes may have been made to the formatting, but no changes have been made to the content.

Content quoted from the IIA web site appears in light grey boxes with an orange border. [1]

Content quoted from the *Standards* or Implementation Guides appears in yellow boxes.

Content quoted from the Practice Advisories appears in orange boxes.

[1] The website is https://na.theiia.org/standards-guidance/Pages/Standards-and-Guidance-IPPF.aspx#mandatory.

Section I – Mandatory Guidance – Introduction

Standards & Guidance — International Professional Practices Framework (IPPF)®

The International Professional Practices Framework (IPPF) is the conceptual framework that organizes authoritative guidance promulgated by The Institute of Internal Auditors. A trustworthy, global, guidance-setting body, The IIA provides internal audit professionals worldwide with authoritative guidance organized in the IPPF as mandatory guidance and recommended guidance.

Mandatory Guidance

Conformance with the principles set forth in mandatory guidance is required and essential for the professional practice of internal auditing. Mandatory guidance is developed following an established due diligence process, which includes a period of public exposure for stakeholder input. The mandatory elements of the IPPF are:

- Core Principles for the Professional Practice of Internal Auditing
- Definition of Internal Auditing
- Code of Ethics
- *International Standards for the Professional Practice of Internal Auditing (Standards)*

Recommended Guidance

Recommended guidance is endorsed by The IIA through a formal approval process. It describes practices for effective implementation of The IIA's Core Principles, Definition of Internal Auditing, Code of Ethics, and Standards. The recommended elements of the IPPF are:

- Implementation Guidance — assist internal auditors in applying the Standards.
- Supplemental Guidance (Practice Guides) — provide detailed processes and procedures for internal audit practitioners.

This graphic from the IIA website provides a visual representation of the IPPF and the Mandatory Guidance and Strongly Recommended Guidance.

When you are presented with a question, look first in the Mandatory Guidance for an answer. If there is no answer in the Mandatory Guidance, look in the Recommended Guidance.

The materials directly reference the IPPF whenever possible.

The Mission of Internal Audit

In the diagram above, the Mission surrounds the entire diagram. The mission describes the goals of the internal audit activity within the organization.

> The Mission of Internal Audit articulates what internal audit aspires to accomplish within an organization. Its place in the New IPPF is deliberate, demonstrating how practitioners should leverage the entire framework to facilitate their ability to achieve the Mission.
>
> To enhance and protect organizational value by providing risk-based and objective assurance, advice, and insight.

> **Exam Tip:** Memorize the Mission of Internal Audit.

Mandatory Guidance

“Mandatory guidance” refers to standards and principles from the IIA that must be followed. “Mandatory” means that it is a requirement, not a suggestion. The four sources of mandatory guidance are:

1) Core Principles for the Professional Practice of Internal Auditing
2) Definition of Internal Auditing
3) Code of Ethics
4) *International Standards for the Professional Practice of Internal Auditing* (*Standards*)

The descriptions in the table below are taken from the IIA website.

Element	Description
Core Principles for the Professional Practice of Internal Auditing	The Core Principles, taken as a whole, articulate internal audit effectiveness. For an internal audit activity to be considered effective, all Principles should be present and operating effectively. How an internal auditor, as well as an internal audit activity, demonstrates achievement of the Core Principles may be quite different from organization to organization, but failure to achieve any of the Principles would imply that an internal audit activity was not as effective as it could be in achieving internal audit's mission.
Definition of Internal Auditing	The Definition of Internal Auditing states the fundamental purpose, nature, and scope of internal auditing. The definition is: Internal auditing is 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.
Code of Ethics	The Code of Ethics states the principles and expectations governing behavior of individuals and organizations in the conduct of internal auditing. It describes the minimum requirements for conduct and behavioral expectations rather than specific activities.
Standards	The *Standards* are principle-focused and provide a framework for performing and promoting internal auditing. The *Standards* are mandatory requirements consisting of: • Statements of basic requirements for the professional practice of internal auditing and for evaluating the effectiveness of its performance. The requirements are internationally applicable for organizations and individuals. • Interpretations, which clarify terms or concepts within the statements. • Glossary Terms It is necessary to consider both Statements and Interpretations to understand and apply the *Standards* correctly. The *Standards* employs terms that have been given specific meanings included in the Glossary.

The Core Principles

There are ten Core Principles:

1) Demonstrates integrity.
2) Demonstrates competence and due professional care.
3) Is objective and free from undue influence (independent).
4) Aligns with the strategies, objectives, and risks of the organization.
5) Is appropriately positioned and adequately resourced.
6) Demonstrates quality and continuous improvement.
7) Communicates effectively.
8) Provides risk-based assurance.
9) Is insightful, proactive, and future-focused.
10) Promotes organizational improvement.

Introduction to the *Standards*

This text from the IIA is an excellent outline of the *Standards* and the objectives of the *Standards*.

Internal auditing is conducted in diverse legal and cultural environments; for 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, conformance with The IIA's *International Standards for the Professional Practice of Internal Auditing* (*Standards*) is essential in meeting the responsibilities of internal auditors and the internal audit activity.

The purpose of the *Standards* is to:

1. Guide adherence with the mandatory elements of the International Professional Practices Framework.
2. Provide a framework for performing and promoting a broad range of value-added internal auditing services.
3. Establish the basis for the evaluation of internal audit performance.
4. Foster improved organizational processes and operations.

The *Standards* are principles-focused, mandatory requirements consisting of:

- **Statements** of core requirements for the professional practice of internal auditing and for evaluating the effectiveness of performance that are internationally applicable at organizational and individual levels.
- **Interpretations** clarifying terms or concepts within the *Standards*.

The *Standards*, together with the Code of Ethics, encompass all mandatory elements of the International Professional Practices Framework; therefore, conformance with the Code of Ethics and the *Standards* demonstrates conformance with all mandatory elements of the International Professional Practices Framework.

The *Standards* employ terms as defined specifically in the Glossary. To understand and apply the *Standards* correctly, it is necessary to consider the specific meanings from the Glossary. Furthermore, the *Standards* use the word "must" to specify an unconditional requirement and the word "should" where conformance is expected unless, when applying professional judgment, circumstances justify deviation.

The *Standards* comprise two main categories: Attribute and Performance Standards. **Attribute Standards** address the attributes of organizations and individuals performing internal auditing. **Performance Standards** describe the nature of internal auditing and provide quality criteria against which the performance of these services can be measured. Attribute and Performance Standards apply to all internal audit services.

Implementation Standards expand upon the Attribute and Performance Standards by providing the requirements applicable to assurance (.A) or consulting (.C) services.

Assurance services involve the internal auditor's objective assessment of evidence to provide opinions or conclusions regarding an entity, operation, function, process, system, or other subject matters. The nature and scope of an assurance engagement are determined by the internal auditor. Generally, three parties are participants in assurance services: (1) the person or group directly involved with the entity, operation, function, 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.

The *Standards* apply to individual internal auditors and the internal audit activity. All internal auditors are accountable for conforming with the standards related to individual objectivity, proficiency, and due professional care and the standards relevant to the performance of their job responsibilities. Chief audit executives are additionally accountable for the internal audit activity's overall conformance with the *Standards*.

If internal auditors or the internal audit activity is prohibited by law or regulation from conformance with certain parts of the *Standards*, conformance with all other parts of the *Standards* and appropriate disclosures are needed.

If the *Standards* are used in conjunction with requirements issued by other authoritative bodies, internal audit communications may also cite the use of other requirements, as appropriate. In such a case, if the internal audit activity indicates conformance with the *Standards* and inconsistencies exist between the *Standards* and other requirements, internal auditors and the internal audit activity must conform with the *Standards* and may conform with the other requirements if such requirements are more restrictive.

The review and development of the *Standards* is an ongoing process. The International Internal Audit Standards Board engages in extensive consultation and discussion before issuing the *Standards*. This includes worldwide solicitation for public comment through the exposure draft process. All exposure drafts are posted on The IIA's website as well as being distributed to all IIA institutes.

Note: The Glossary mentioned in this section is presented in Appendix A and the content comes from the IIA.

Note: As we go through the materials, we will provide the text of the actual *Standard* when we believe that is the best way to cover a topic. We will add additional notes and comments as needed, but we believe that being familiar with the text of the *Standards* is one of the best ways to prepare for the exam.

Types of *Standards*

1) Attribute Standards

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

- **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.
- **Independence and Objectivity (1100)**: The internal audit activity must be independent and the internal auditors must be objective in performing their work.
- **Proficiency and Due Professional Care (1200)**: Engagement must be performed with proficiency and due professional care.
- **Quality Assurance and Improvement Program (1300)**: The Chief Audit Executive (CAE, the head of the IAA) must develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity and must also continuously monitor 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. Furthermore, the program must provide assurance that the internal audit activity conforms to the **Definition of Internal Auditing**, the ***Standards*,** and the **Code of Ethics.**

2) Performance Standards

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:

- **Managing the Internal Audit Activity (2000)**: The CAE must effectively manage the internal audit activity to ensure that it adds value to the organization.
- **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.
- **Engagement Planning (2200)**: Internal auditors must develop and record a plan for each engagement, including the scope objectives, timing, and resource allocations.
- **Performing the Engagement (2300)**: Internal auditors must identify, analyze, evaluate, and record sufficient information to achieve the engagement's objectives.
- **Communicating Results (2400)**: Internal auditors must communicate the engagement results.
- **Monitoring Progress (2500)**: The CAE must establish and maintain a system to monitor the disposition of results communicated to management.
- **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.

3) Implementation Standards

Implementation Standards apply to the two 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, which are for assurance and consulting, respectively.

1) **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:

   - **The process owner**, or the person or group directly involved with the process, system, or other subject matter
   - **The internal auditor**, or the person or group making the assessment
   - **The user**, or the person or group using the assessment

2) **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:

   - **The internal auditor**, or the person or group offering the advice
   - **The engagement client**, or the person or group seeking and receiving the advice

   It should be noted here that the internal auditor should maintain objectivity and not assume management responsibility when performing consulting services.

Recommended Guidance

Note: Previously, there was a category of recommended guidance called Practice Advisories (PAs). The PAs provided very good and detailed guidance for the application of the Standards and were the best practices endorsed by the IIA for applying the Definition, Code of Ethics, and Standards. While the PAs are no longer included in the Recommended Guidance, they are included here where appropriate. The PAs tend to be longer and more detailed than the Implementation Guides; however, they are still an excellent tool for preparing for the exam.

1) Implementation Guidance

Implementation Guides assist internal auditors in applying the Standards. They collectively address internal auditing's approach, methodologies, and consideration, but do not detail processes or procedures.

2) Supplemental Guidance

Supplemental Guidance provides detailed guidance for conducting internal audit activities. These include topical areas, sector-specific issues, as well as processes and procedures, tools and techniques, programs, step-by-step approaches, and examples of deliverables.

A. Definition of Internal Auditing

The Definition of Internal Auditing states the fundamental purpose, nature, and scope of internal auditing.

Internal auditing is 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.

Exam Tip: Memorize the Definition of Internal Auditing.

The Purpose, Authority, and Responsibility of the Internal Audit Activity

Standard 1000: Purpose, Authority, and Responsibility

The purpose, authority, and responsibility of the internal audit activity must be formally defined in an internal audit charter, consistent with the Mission of Internal Audit and the mandatory elements of the International Professional Practices Framework (the Core Principles for the Professional Practice of Internal Auditing, the Code of Ethics, the Standards, and the Definition of Internal Auditing). The chief audit executive must periodically review the internal audit charter and present it to senior management and the board for approval.

Internal auditing has grown as a profession because of the general expectation for public companies to have an internal audit activity and an audit committee composed of non-management directors.

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

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 are responsible for the organization's internal control. Internal auditors 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. This assistance is one of the ways in which the internal audit activity adds value to an organization.

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; in other words, assessing the quality of performance in carrying out assigned responsibilities.
- Evaluating the adequacy and effectiveness of the control system in a systematic and thorough manner.
- Examining and evaluating 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 the degree to which the organization is in compliance with policies, plans, procedures, and regulations.
- Examining and evaluating 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 reviewed activities to the management of the organization in order to assist them in the effective discharge of their responsibilities.

The Internal Audit Charter

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

Included in the Charter

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[2]
3) The **authority** that the internal audit activity has to **access records, personnel, and physical properties**
4) The **accountability** of the internal audit activity
5) The **responsibility** of the internal audit activity

Note: A sample charter from the IIA is detailed in Appendix B.

[2] 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 they are covered later in more detail.

IAA Reporting Lines

The IAA should report to an organizational level that is high enough to be effective; furthermore, the IAA should be **independent of the functions that will be audited**. Ideally, the director of the internal audit department (the Chief Audit Executive, or CAE) should report to the Chief Executive Officer (CEO) or board of directors. The accounting department, chief accountant, or finance director would not normally be an appropriate level to report to. An increasing number of companies prefer 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 CEO (or a similar position).

> **Note:** The audit committee is a subcommittee of the board of directors, and its role is becoming more important and visible in the wake of numerous and well-reported accounting scandals.

Organizational Independence

A well-written charter adds to the organizational independence of the IAA. If the duties, responsibilities, authority, and objectives are spelled out clearly, the IAA will not need to rely on outsiders to perform his or her duties. A poorly written charter, one that does not establish the IAA properly, will not be perceived as important or valuable to the company and its effectiveness will be diminished by those who do not think that they need to cooperate with the IAA.

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

Practice Advisory 1000-1: Internal Audit Charter

Interpretation:

The internal audit charter is a formal document that defines the internal audit activity's purpose, authority, and responsibility. The internal audit charter establishes the internal audit activity's position within the organization, including the nature of the chief audit executive's functional reporting relationship with the board; authorizes access to records, personnel, and physical properties relevant to the performance of engagements; and defines the scope of internal audit activities. Final approval of the internal audit charter resides with the board.

1. Providing a formal, written internal audit charter is critical in managing the internal audit activity. The internal audit charter provides a recognized statement for review and acceptance by management and for approval, as documented in the minutes, by the board. It also facilitates a periodic assessment of the adequacy of the internal audit activity's purpose, authority, and responsibility, which establishes the role of the internal audit activity. If a question should arise, the internal audit charter provides a formal, written agreement with management and the board about the organization's internal audit activity.

2. The chief audit executive (CAE) is responsible for periodically assessing whether the internal audit activity's purpose, authority, and responsibility, as defined in the internal audit charter, continue to be adequate to enable the activity to accomplish its objectives. The CAE is also responsible for communicating the result of this assessment to senior management and the board.

Implementation Standards:

1000.A1 – The nature of assurance services provided to the organization must be defined in the internal audit charter. If assurances are to be provided to parties outside the organization, the nature of these assurances must also be defined in the internal audit charter.

1000.C1 – The nature of consulting services must be defined in the internal audit charter.

Standard 1010 – Recognition of the Definition of Internal Auditing, the Code of Ethics, and the Standards in the Internal Audit Charter

The mandatory nature of the Core Principles for the Professional Practice of Internal Auditing, the Code of Ethics, the *Standards*, and the Definition of Internal Auditing must be recognized in the internal audit charter. The chief audit executive should discuss the Mission of Internal Audit and the mandatory elements of the International Professional Practices Framework with senior management and the board.

Organizational Status of the Internal Audit Activity

In order to have the **organizational status** to fulfill its responsibilities, the internal audit activity 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 being audited cooperate with them. If the board and audit committee do not support the work of the IAA, others in the organization may not support their efforts.

The internal audit department must also have **organizational independence**, meaning that the internal audit activity must not have any current or previous relationships with the departments it audits. Furthermore, internal auditors should not be assigned to engagements with departments in which they previously worked.

The correct level of organizational status and independence can be achieved through a properly designed Internal Audit Charter.

The Audit Committee

The audit committee, which is typically a subcommittee of the board of directors, receives reports from external and internal auditors and conveys the auditors' views to the board. The audit committee usually oversees the work of the IAA and manages the relationship with the external auditor. Audit committee members **should be independent non-executive directors** who do not have a role in the day-to-day running of the company and who do not have any financial interest or other relationship (such as providing consulting services) with the company.

Note: The number of audit-committee members varies, but it is usually between three and nine.

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

- To ensure that the external auditors are completely independent of the company and its subsidiaries, and that they are working for the best interests of the shareholders.
- To ensure that the company complies with all laws and regulations, and that the necessary reports are filed with the appropriate 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

The audit committee has other specific functions:

- Receiving copies of all external and internal audit reports and communications, and also 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.
- 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.
- Reviewing policies to eliminate illegal and unethical practices.

Question 1: 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 2: 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 3: 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 internal audit 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)

Question 4: 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 criteria, 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)

Consulting Services

Note: This discussion of consulting services is included here to address the full scope of services that the internal audit activity may provide.

The *Standards* Glossary defines consulting services as: "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 IIA *Standards* say that internal auditors can **only** perform consulting services specifically defined in the internal audit charter.

Consulting engagements may be formal or informal and they may or may not be connected to an assurance engagement. Ultimately, the CAE determines the particular form and function of a consulting engagement and also decides if an assurance engagement is better suited for the needs of the company than a consulting engagement.

The IIA's Practice Advisories (2006) listed twelve principles to guide internal auditors during consulting engagements. The Practice Advisories, formerly PA 1000.C1-1, have since been eliminated but the principles they outlined can serve as a useful guide for internal auditors. The following list is a condensed version of these twelve principles:

- **Value is added by the IAA when he or she performs both assurance and consulting services.** In fact, the IAA is in a strong position to provide consulting services because of its professional standards and its knowledge of the company and its operations.
- **Included in the internal audit charter is the provision that the IAA provide consulting and other appropriate services.** Additionally, any rules or standards applicable to the consulting services must also be stated in the charter.
- **The IAA may also provide other services besides assurance and consulting, such as investigating fraud and conducting due diligence.**
- **Consulting services do not impair the objectivity of either the individual internal auditor or the IAA.** However, the auditor's first duty is as an auditor, and so all actions need to be governed by the applicable internal audit guidelines and standards. 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 all understand and agree with the concept, operating guidelines, and communications required for performing consulting engagements.

B. IIA Code of Ethics

The Code of Ethics is intended to be an **ethical guide** for internal auditors. It does not provide specific guidance nor does it prescribe defined actions.

Note: Memorize the Code of Ethics so that you are able to identify any key words that may be in an answer choice or the question itself. Items in brackets have been added by HOCK.

The Code of Ethics states the principles and expectations governing the behavior of individuals and organizations in the conduct of internal auditing. It describes the minimum requirements for conduct, [sic] and behavioral expectations rather than specific activities.

Introduction to the Code of Ethics

The purpose of The Institute's Code of Ethics is to promote an ethical culture in the profession of internal auditing.

Internal auditing is 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.

A code of ethics is necessary and appropriate for the profession of internal auditing, founded as it is on the trust placed in its objective assurance about governance, risk management, and control.

The Institute's Code of Ethics extends beyond the Definition of Internal Auditing to include two essential components:

- Principles that are relevant to the profession and practice of internal auditing.
- Rules of Conduct that describe behavior norms expected of internal auditors. These rules are an aid to interpreting the Principles into practical applications and are intended to guide the ethical conduct of internal auditors.

"Internal auditors" refers to Institute members, recipients of or candidates for IIA professional certifications, and those who perform internal audit services within the Definition of Internal Auditing.

Applicability and Enforcement of the Code of Ethics

This Code of Ethics applies to both entities and individuals that perform internal audit services.

For IIA 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 Directives. 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.

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.

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, accepting a material gift would 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.

Note: Specific aspects of the Code of Ethics are covered in more detail later in this book.

Question 5: 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)

C. International Standards

The Standards have already been discussed above, so we will not discuss them again here from an overall perspective. There are seven subtopics of international standards to cover.

C1. Comply with the IIA's Attribute Standards

In addition to understanding the IIA's attribute standards, it is critical that the IAA communicates them to engagement clients. By communicating this information about what the IAA does and does not do, there will be a reduction in the number of misunderstandings between the IAA and the engagement clients. This will enable the IAA to better fulfill its duties and responsibilities.

C2. Maintain Independence and Objectivity

Independence and Objectivity

Standard 1100 – Independence and Objectivity

The internal audit activity must be independent, and internal auditors must be objective in performing their work.

Interpretation:

Independence is the freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the chief audit executive has **direct and unrestricted access to senior management and the board**. This can be achieved through a dual-reporting relationship. Threats to independence must be managed at the individual auditor, engagement, functional, and organizational levels.

Objectivity is an unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no quality compromises are made. Objectivity requires that internal auditors do not subordinate their judgment on audit matters to others. Threats to objectivity must be managed at the individual auditor, engagement, functional, and organizational levels.

Fostering Independence

Independence is an important issue both for external auditors and internal auditors. However, because internal auditors work directly for the company that employs them, it is impossible for internal auditors to be independent in the same manner as external auditors. Therefore, internal auditors refer to the way in which they act in the performance of their work as "objective" rather than "independent." **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. Therefore, other individuals or groups within the company should not be able to influence or affect the work and the conclusions of the internal auditors.

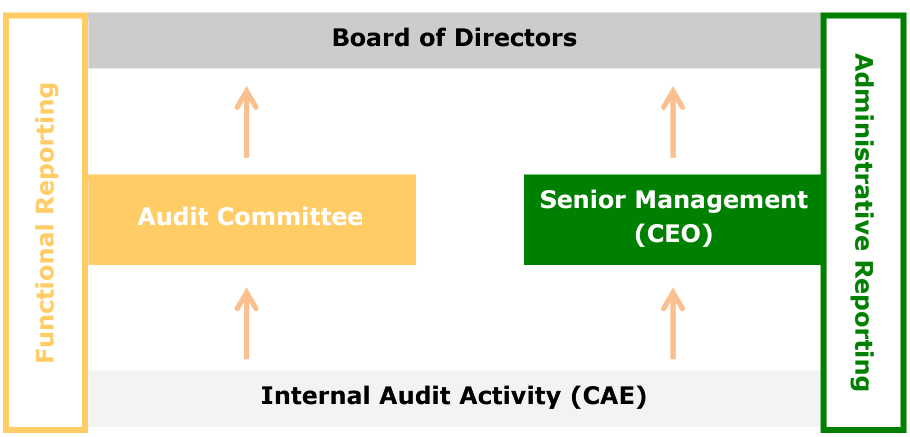
This independence is achieved largely through the organizational status of the IAA. If the IAA is perceived to be important and report to the board of directors, they will be more independent because of the support they receive from the highest levels of the organization. If, on the other hand, they report only to the chief accountant and there is a perception in the organization that they do not add value to the organization (or are not respected by the board), the IAA will have less independence and their work will be less useful to the organization.

The crucial element of having organizational independence is for the CAE to have a reporting line in the organization that will allow the IAA to fulfill its tasks. Therefore, it is vital for IAAs 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 CEO** and **functionally** to the audit committee, board of directors, or some other appropriate governing authority.

Functional Reporting is the ultimate source of independence and authority for the IAA. The IIA recommends that the CAE report functionally to the audit committee, board of directors, or other appropriate governing authority. Specific items included in administrative reporting are listed in the Interpretation to Standard 1110 (shown below) and Practice Advisory 1110-1, Paragraph 3 (shown below).

Administrative Reporting is the reporting relationship within the organization's management structure that facilitates the day-to-day operations of the IAA. This would be someone like the CEO, but ultimately the administrative reporting goes to the Board since the CEO reports to the Board. Specific items included in administrative reporting are listed in Practice Advisory 1110-1, Paragraph 4 (shown below).



The differences in these two different reporting lines are significant. For example, if an internal audit department needs to buy office supplies, it is not going to go to the audit committee to get approval. These types of issues should go to an administrative person, perhaps the Chief Financial Officer (CFO) or CEO.

Though the IAA must functionally report to the board, the board should not be able to influence the work that the IAA does or the results of the work. From the *Standards*: "The internal audit activity must be free from interference in determining the scope of internal auditing, performing work, and communicating results."

Thus, all decisions about which engagements to perform, the manner in which to perform them, and the conclusions that are drawn should all be done without interference from the board.

Standard 1110 – Organizational Independence

The chief audit executive must report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. The chief audit executive must confirm to the board, at least annually, the organizational independence of the internal audit activity.

Interpretation:

Organizational independence is effectively achieved when the chief audit executive **reports functionally to the board**. Examples of functional reporting to the board involve the board:

- Approving the internal audit charter;
- Approving the risk based internal audit plan;
- Approving the internal audit budget and resource plan;
- Receiving communications from the chief audit executive on the internal audit activity's performance relative to its plan and other matters;
- Approving decisions regarding the appointment and removal of the chief audit executive;
- Approving the remuneration of the chief audit executive; and
- Making appropriate inquiries of management and the chief audit executive to determine whether there are inappropriate scope or resource limitations.

1110.A1 – The internal audit activity must be free from interference in determining the scope of internal auditing, performing work, and communicating results. The chief audit executive must disclose such interference to the board and discuss the implications.

Practice Advisory 1110-1

1. Support from senior management and the board assists the internal audit activity in gaining the cooperation of engagement clients and performing their work free from interference.
2. The chief audit executive (CAE), **reporting functionally to the board and administratively to the organization's chief executive officer**, facilitates organizational independence. At a minimum the CAE needs to report to an individual in the organization with sufficient authority to promote independence and to ensure broad audit coverage, adequate consideration of engagement communications, and appropriate action on engagement recommendations.
3. **Functional reporting to the board typically involves the board**:

- Approving the internal audit activity's overall charter.
- Approving the internal audit risk assessment and related audit plan.
- Receiving communications from the CAE on the results of the internal audit activities or other matters that the CAE determines are necessary, including private meetings with the CAE without management present, as well as annual confirmation of the internal audit activity's organizational independence.
- Approving all decisions regarding the performance evaluation, appointment, or removal of the CAE.
- Approving the annual compensation and salary adjustment of the CAE.
- Making appropriate inquiries of management and the CAE to determine whether there is audit scope or budgetary limitations that impede the ability of the internal audit activity to execute its responsibilities.

4. **Administrative reporting** is the reporting relationship within the organization's management structure that facilitates the **day-to-day operations of the internal audit activity**. Administrative reporting typically includes:

- Budgeting and management accounting.
- Human resource administration, including personnel evaluations and compensation.
- Internal communications and information flows.
- Administration of the internal audit activity's policies and procedures.

Direct Interaction with the Board

Standard 1110 states: "The chief audit executive must confirm to the board, at least annually, the organizational independence of the internal audit activity."

In addition to this specific requirement, there are other things that the CAE must communicate to the board. Standard 1111 and its Practice Advisory 1111-1 provide specific guidance about this.

Practice Advisory 1111-1 – Board Interaction

The chief audit executive must communicate and interact directly with the board.

1. Direct communication occurs when the chief audit executive **(CAE) regularly attends and participates in board meetings** that relate to the board's oversight responsibilities for auditing, financial reporting, organizational governance, and control. The CAE's attendance and participation at these meetings provide an opportunity to be apprised of strategic business and operational developments, and to raise high-level risk, systems, procedures, or control issues at an early stage. Meeting attendance also provides an opportunity to exchange information concerning the internal audit activity's plans and activities and to keep each other informed on any other matters of mutual interest.
2. Such communication and interaction also occurs when the CAE meets privately with the board, at least annually.

Fostering Objectivity

Standard 1120: Individual Objectivity

Having objectivity means that the individual will make the conclusion or decision based on the facts at hand without being influenced by feelings, emotions, relationships with others, 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.

Standard 1120 – Individual Objectivity

Internal auditors must have an impartial, unbiased attitude and avoid any conflict of interest.

Interpretation:

Conflict of interest is **a situation in which an internal auditor, who is in a position of trust, has a competing professional or personal interest**. Such competing interests can make it difficult to fulfill his or her duties impartially. A conflict of interest exists even if no unethical or improper act results. **A conflict of interest can create an appearance of impropriety** that can undermine confidence in the internal auditor, the internal audit activity, and the profession. A conflict of interest could impair an individual's ability to perform his or her duties and responsibilities objectively.

Note: Correctly answering conflict of interest questions on the exam can be especially difficult; therefore, be particularly aware of the principles of objectivity and the ways to recognize and avoid situations where objectivity could be impaired.

In order to maintain individual objectivity for an IAA, job assignments should be made to minimize potential conflicts of interests. For example, an IAA might be prevented from auditing an area where his or her spouse or good friend works. Furthermore, jobs should be periodically rotated so that no relationships develop between the auditor and the auditee that might impair the auditor's judgment.

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

Note: An internal auditor can make recommendations to a department as part of a consulting engagement and still be objective in a future financial audit of that same department.

Practice Advisory 1120-1

1) Individual objectivity means the internal auditors perform engagements in such a manner that they have an honest belief in their work product and that no significant quality compromises are made. Internal auditors are not to be placed in situations that could impair their ability to make objective professional judgments.

2) Individual objectivity involves the chief audit executive (CAE) organizing staff assignments that prevent potential and actual conflict of interest and bias, periodically obtaining information from the internal audit staff concerning potential conflict of interest and bias, and, when practicable, rotating internal audit staff assignments periodically.

3) Review of internal audit work results before the related engagement communications are released assists in providing reasonable assurance that the work was performed objectively.

4) The internal auditor's objectivity is not adversely affected when the auditor recommends standards of control for systems or reviews procedures before they are implemented. The auditor's objectivity is considered to be impaired if the auditor designs, installs, drafts procedures for, or operates such systems.

5) The occasional performance of non-audit work by the internal auditor, with full disclosure in the reporting process, would not necessarily impair objectivity. However, it would require careful consideration by management and the internal auditor to avoid adversely affecting the internal auditor's objectivity.

Impairments to Independence or Objectivity

1130 – Impairment to Independence or Objectivity

If independence or objectivity is impaired in fact or appearance, the **details of the impairment must be disclosed to appropriate parties**. The nature of the disclosure will depend upon the impairment.

There are a large number of situations in which the internal auditor's independence or objectivity might be impaired. An impairment is anything that might cause the auditor to be less than completely objective in an engagement. Common impairments include a personal conflict of interest, 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).

If an impairment arises during an engagement, it must be reported immediately to the manager of the engagement so that the situation can be addressed or eliminated.

Note: It is 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. However, objectivity is considered to be impaired if the auditor **designs**, **installs**, **drafts procedures** for, or **operates** such systems.

Standard 1130 Interpretation:

Impairment to organizational independence and individual objectivity may include, but is not limited to, personal conflict of interest, scope limitations, restrictions on access to records, personnel, and properties, and resource limitations, such as funding.

The determination of appropriate parties to which the details of an impairment to independence or objectivity must be disclosed is dependent upon the expectations of the internal audit activity's and the chief audit executive's responsibilities to senior management and the board as described in the internal audit charter, as well as the nature of the impairment.

1130.A1 – Internal auditors must refrain from assessing specific operations for which they were previously responsible. Objectivity is presumed to be impaired if an internal auditor provides assurance services for an activity for which the internal auditor had responsibility within the previous year.

1130.A2 – Assurance engagements for functions over which the chief audit executive has responsibility must be overseen by a party outside the internal audit activity.

1130.A3 – The internal audit activity may provide assurance services where it had previously performed consulting services, provided the nature of the consulting did not impair objectivity and provided individual objectivity is managed when assigning resources to the engagement.

1130.C1 – Internal auditors may provide consulting services relating to operations for which they had previous responsibilities.

1130.C2 – 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.

Note: A **scope limitation** is a restriction on the work that the internal audit activity wants to perform that prevents it from accomplishing its objectives and plans. A scope limitation might restrict the IAA's access to records, personnel, or properties relevant to the performance of an engagement.

Assessing Operations for Which Internal Auditors Were Previously Responsible (1130.A1)

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 an individual is assigned to an engagement where he or she worked in the past year, objectivity is presumed be impaired and such 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.

Practice Advisory 1130.A1-1: Assessing Operations for Which Internal Auditors Were Previously Responsible

Primary Related Standard 1130.A1 – Internal auditors must refrain from assessing specific operations for which they were previously responsible. **Objectivity is presumed to be impaired if an auditor provides assurance services for an activity for which the auditor had responsibility within the previous year**.

Persons transferred to, or temporarily engaged by, the internal audit activity should not be assigned to audit those activities they previously performed or for which they had management responsibility until at least one year has elapsed. Such assignments are presumed to impair objectivity, and additional consideration should be exercised when supervising the engagement work and communicating engagement results.

Internal Audit's Responsibility for Other (Non-audit) Functions (1130.A2)

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 "they are not functioning as an internal auditor."

However, it is possible that management **may insist** on such an assignment. If such an event happens, 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.

Practice Advisory 1130.A2-1: Internal Audit's Responsibility for Other (Non-audit) Functions

Primary Related Standard 1130.A2 – Assurance engagements for functions over which the chief audit executive has responsibility **must be overseen by a party outside the internal audit activity**.

1. Internal auditors are **not to accept responsibility for non-audit functions or duties that are subject to periodic internal audit assessments**. If they have this responsibility, then they are not functioning as internal auditors.
2. When the internal audit activity, chief audit executive (CAE), or individual internal auditor is responsible for, or management is considering assigning, an operational responsibility that the internal audit activity might audit, the **internal auditor's independence and objectivity may be impaired**. At a minimum, the CAE needs to consider the following factors in assessing the impact on independence and objectivity:

- Requirements of the Code of Ethics and the Standards.
- Expectations of stakeholders that may include the shareholders, board of directors, management, legislative bodies, public entities, regulatory bodies, and public interest groups.
- Allowances and/or restrictions contained in the internal audit charter.
- Disclosures required by the Standards.
- Audit coverage of the activities or responsibilities undertaken by the internal auditor.

- Significance of the operational function to the organization (in terms of revenue, expenses, reputation, and influence).
- Length or duration of the assignment and scope of responsibility.
- Adequacy of separation of duties.
- Whether there is any history or other evidence that the internal auditor's objectivity may be at risk.

3. If the internal audit charter contains specific restrictions or limiting language regarding the assignment of non-audit functions to the internal auditor, then disclosure and discussion with management of such restrictions is necessary. If management insists on such an assignment, then disclosure and discussion of this matter with the board is necessary. If the internal audit charter is silent on this matter, the guidance noted in the points below are to be considered. All the points noted below are subordinate to the language of the internal audit charter.
4. When the internal audit activity accepts operational responsibilities and that operation is part of the internal audit plan, the CAE needs to:

- Minimize the impairment to objectivity by using a contracted, third-party entity or external auditors to complete audits of those areas reporting to the CAE.
- Confirm that individuals with operational responsibility for those areas reporting to the CAE do not participate in internal audits of the operation.
- Ensure that internal auditors conducting the assurance engagement of those areas reporting to the CAE are supervised by, and report the results of the assessment, to senior management and the board.
- Disclose the operational responsibilities of the internal auditor for the function, the significance of the operation to the organization (in terms of revenue, expenses, or other pertinent information), and the relationship of those who audited the function.

5. The auditor's operational responsibilities need to be disclosed in the related audit report of those areas reporting to the CAE and in the internal auditor's standard communication to the board. Results of the internal audit may also be discussed with management and/or other appropriate stakeholders. Impairment disclosure does not negate the requirement that assurance engagements for functions over which the CAE has responsibility need to be overseen by a party outside the internal audit activity.

Question 6: 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 four 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 (1130.C1 and C2)

For many reasons, it is becoming more common for internal auditors to provide consulting services relating to operations for which they had previous responsibilities. Internal auditors may provide consulting services to areas over which they had previous responsibility, but the auditors must still act in an independent and objective manner. Any potential impairment to their independence or objectivity must be disclosed to the engagement client before the engagement is accepted.

Standard 1130.C1 – Internal auditors may provide consulting services relating to operations for which they had previous responsibilities.

Standard 1130.C2 – 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.

Question 7: 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)

C3-4. Proficiency and Necessary Skills

Standard 1200: Proficiency and Due Professional Care

Engagements must be performed with **proficiency and due professional care**.

Practice Advisory 1200-1: Proficiency and Due Professional Care

Proficiency and due professional care are the **responsibility of the chief audit executive (CAE) and each internal auditor**. As such, the CAE ensures that persons assigned to each engagement collectively possess the necessary knowledge, skills, and other competencies to conduct the engagement appropriately.

Due professional care includes conforming with the Code of Ethics and, as appropriate, the organization's code of conduct as well as the codes of conduct for other professional designations the internal auditors may hold. The Code of Ethics extends beyond the Definition of Internal Auditing to include two essential components:

- Principles that are relevant to the profession and practice of internal auditing: integrity, objectivity, confidentiality, and competency.
- Rules of conduct that describe behavioral norms expected of internal auditors. These rules are an aid to interpreting the principles into practical applications and are intended to guide the ethical conduct of internal auditors.

Standard 1210: Proficiency

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**. Essentially this Standard states that the internal auditors must be competent.

In an overall sense for the IAA, professional proficiency is the responsibility of the CAE. However, each internal auditor also has a responsibility for individual proficiency. The skills that are necessary for an internal auditor to be proficient will depend on his or her work. If a person does a great deal 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.

Standard 1210 – Proficiency

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**.

Interpretation:

Proficiency is a collective term that refers to the knowledge, skills, and other competencies required of internal auditors to effectively carry out their professional responsibilities. It encompasses consideration of current activities, trends, and emerging issues, to enable relevant advice and recommendations. Internal auditors are encouraged to demonstrate their proficiency by obtaining appropriate professional certifications and qualifications, such as the Certified Internal Auditor designation and other designations offered by The Institute of Internal Auditors and other appropriate professional organizations.

1210.A1 – The chief audit executive must obtain competent advice and assistance if the internal auditors lack the knowledge, skills, or other competencies needed to perform all or part of the engagement.

1210.A2 – Internal auditors must have **sufficient knowledge to evaluate the risk of fraud** and the manner in which it is managed by the organization, but are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud.

1210.A3 – Internal auditors must have **sufficient knowledge of key information technology risks and controls** and available technology-based audit techniques to perform their assigned work. However, not all internal auditors are expected to have the expertise of an internal auditor whose primary responsibility is information technology auditing.

1210.C1 – The chief audit executive must decline the consulting engagement or obtain competent advice and assistance if the internal auditors lack the knowledge, skills, or other competencies needed to perform all or part of the engagement.

Proficiency, Understanding and Appreciation

In Practice Advisory 1210-1 (reproduced in full below), there are three levels of competence listed as well as areas in which the internal auditor should have this level of competence:

1) **Proficiency:** The ability to apply knowledge to situations likely to be encountered and to deal with them appropriately without extensive recourse to technical research and assistance.

2) **Understanding:** An understanding means the ability to apply broad knowledge to situations likely to be encountered, to recognize significant deviations, and to be able to carry out the research necessary to arrive at reasonable solutions.

3) **Appreciation:** The ability to recognize the existence of problems or potential problems and to identify the additional research to be undertaken or the assistance to be obtained. This means that an auditor may not necessarily have to be able to perform a given task; however, the auditor should be able to recognize that such work is needed.

Example: A company has a receivable turnover rate of 4 and days in receivable 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, meaning its impact on the cash cycle, profit and loss, and so forth. **Proficiency** means being able to solve the problem.

The areas that are included in each level of competency are:

Proficiency	In applying • internal audit standards • procedures • techniques in performing engagements. In accounting principles and techniques **if internal auditors work extensively** with financial records and reports.
Understanding	Of management principles to **recognize and evaluate** the • materiality, and • significance of deviations from good business practices.
Appreciation	The fundamentals of business subjects such as • accounting • economics • commercial law • taxation • finance • quantitative methods • information technology • risk management • fraud

Knowledge and Skills

In addition to the three competencies listed above, knowledge and skills are also stated in the Practice Advisory.

Auditors must have knowledge to **identify the indicators of fraud and knowledge of key information technology risks and controls and available technology-based audit techniques**.

The areas in which **skills** are required are:

- Dealing with people
- Understanding human relations
- Maintaining satisfactory relationships with engagement clients
- Skills in oral and written communications to clearly and effectively convey such matters as engagement objectives, evaluations, conclusions, and recommendations

Responsibility of CAE

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. If the CAE determines that the needed skills and competencies do not exist within the IAA, they must go outside the IAA to get those skills and competencies. This is covered in Practice Advisory 1210.A1-1, which we look at next.

Practice Advisory 1210-1: Proficiency

1. The knowledge, skills, and other competencies referred to in the standard include:

- **Proficiency** in applying internal audit standards, procedures, and techniques in performing engagements. Proficiency means the ability to apply knowledge to situations likely to be encountered and to deal with them appropriately without extensive recourse to technical research and assistance.
- **Proficiency** in accounting principles and techniques if internal auditors work extensively with financial records and reports.
- **Knowledge** to identify the indicators of fraud.
- **Knowledge** of key information technology risks and controls and available technology-based audit techniques.
- An **understanding** of management principles to recognize and evaluate the materiality and significance of deviations from good business practices. An understanding means the ability to apply broad knowledge to situations likely to be encountered, to recognize significant deviations, and to be able to carry out the research necessary to arrive at reasonable solutions.
- An **appreciation** of the fundamentals of business subjects such as accounting, economics, commercial law, taxation, finance, quantitative methods, information technology, risk management, and fraud. An appreciation means the ability to recognize the existence of problems or potential problems and to identify the additional research to be undertaken or the assistance to be obtained.
- **Skills** in dealing with people, understanding human relations, and maintaining satisfactory relationships with engagement clients.
- **Skills** in oral and written communications to clearly and effectively convey such matters as engagement objectives, evaluations, conclusions, and recommendations.

2. Suitable criteria of education and experience for filling internal audit positions is established by the chief audit executive (CAE) who gives due consideration to the scope of work and level of responsibility and obtains reasonable assurance as to each prospective auditor's qualifications and proficiency.

3. The internal audit activity needs to collectively possess the knowledge, skills, and other competencies essential to the practice of the profession within the organization. Performing an annual analysis of an internal audit activity's knowledge, skills, and other competencies helps identify areas of opportunity that can be addressed by continuing professional development, recruiting, or co-sourcing.

4. **Continuing professional development is essential** to help ensure internal audit staff remains proficient.

5. The **CAE may obtain assistance from experts outside the internal audit activity** to support or complement areas where the internal audit activity is not sufficiently proficient.

Question 8: 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 9: 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)

1210.A1 – The chief audit executive **must obtain competent advice and assistance if the internal auditors lack the knowledge, skills, or other competencies needed to perform all or part of the engagement**.

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 the IAA or organization to get those skills. External auditors, specialists, or other service providers such as actuaries, appraisers, environmental specialists, fraud investigators, statisticians, lawyers, and so forth can be used if the IAA does not have the necessary skills and/or competencies.

The catalog 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. Some of the types of engagements are (listed in Paragraph 3 of PA 1210.A1-1):

- 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 (for example, oil reserves)
- Fraud
- Interpretations of legal or tax matters
- 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 these reservations 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 (listed in Paragraph 5 of PA 1210.A1-1, reproduced in full below):

- The relevant professional certifications and/or membership in a professional organization
- Experience and education in similar situations and the area in which they will be engaged
- Reputation
- Knowledge of the business and industry

The CAE also needs to consider the **independence and objectivity** of the expert in respect to the engagement (Paragraph 7 of PA 1210.A1-1). 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 (for example, 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 work directly for 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 tasks performed by an outside expert must be reviewed by either the CAE or other internal person. Whoever does the review must have 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 the CAE should assess whether or not the work done and conclusions drawn were reasonable, unbiased, and address all of the issues of the engagement.

Practice Advisory 1210.A1-1

1. Each member of the internal audit activity need not be qualified in all disciplines. The internal audit activity may use external service providers or internal resources that are qualified in disciplines such as accounting, auditing, economics, finance, statistics, information technology, engineering, taxation, law, environmental affairs, and other areas as needed to meet the internal audit activity's responsibilities.
2. An external service provider is a person or firm, independent of the organization, who has special knowledge, skill, and experience in a particular discipline. External service providers include actuaries, accountants, appraisers, culture or language experts, environmental specialists, fraud investigators, lawyers, engineers, geologists, security specialists, statisticians, information technology specialists, the organization's external auditors, and other audit organizations. An external service provider may be engaged by the board, senior management, or the chief audit executive (CAE).
3. External service providers may be used by the internal audit activity in connection with, among other things:

- Achievement of the objectives in the engagement work schedule.
- Audit activities where a specialized skill and knowledge are needed such as information technology, statistics, taxes, or language translations.
- Valuations of assets such as land and buildings, works of art, precious gems, investments, and complex financial instruments.
- Determination of quantities or physical condition of certain assets such as mineral and petroleum reserves.
- Measuring the work completed and to be completed on contracts in progress.
- Fraud and security investigations.
- Determination of amounts, by using specialized methods such as actuarial determinations of employee benefit obligations.
- Interpretation of legal, technical, and regulatory requirements.
- Evaluation of the internal audit activity's quality assurance and improvement program in conformance with the Standards.
- Mergers and acquisitions.
- Consulting on risk management and other matters.

4. When the CAE intends to use and rely on the work of an external service provider, **the CAE needs to consider the competence, independence, and objectivity of the external service provider** as it relates to the particular assignment to be performed. The assessment of competency, independence, and objectivity is also needed when the external service provider is selected by senior management or the board, and the CAE intends to use and rely on the external service provider's work. When the selection is made by others and the CAE's assessment determines that he or she should not use and rely on the work of the external service provider, communication of such results is needed to senior management or the board, as appropriate.
5. The **CAE determines that the external service provider possesses the necessary knowledge, skills, and other competencies to perform the engagement by considering**:

- Professional certification, license, or other recognition of the external service provider's competence in the relevant discipline.
- Membership of the external service provider in an appropriate professional organization and adherence to that organization's code of ethics.

(continued)

- The reputation of the external service provider. This may include contacting others familiar with the external service provider's work.
- The external service provider's experience in the type of work being considered.
- The extent of education and training received by the external service provider in disciplines that pertain to the particular engagement.
- The external service provider's knowledge and experience in the industry in which the organization operates.

6. The CAE needs to assess the relationship of the external service provider to the organization and to the internal audit activity to ensure that independence and objectivity are maintained throughout the engagement. In performing the assessment, the CAE verifies that there are no financial, organizational, or personal relationships that will prevent the external service provider from rendering impartial and unbiased judgments and opinions when performing or reporting on the engagement.
7. The CAE assesses the independence and objectivity of the external service provider by considering:

- The financial interest the external service provider may have in the organization.
- The personal or professional affiliation the external service provider may have to the board, senior management, or others within the organization.
- The relationship the external service provider may have had with the organization or the activities being reviewed.
- The extent of other ongoing services the external service provider may be performing for the organization.
- Compensation or other incentives that the external service provider may have.

8. If the external service provider is also the organization's external auditor and the nature of the engagement is extended audit services, the CAE needs to ascertain that work performed does not impair the external auditor's independence. Extended audit services refer to those services beyond the requirements of audit standards generally accepted by external auditors. If the organization's external auditors act or appear to act as members of senior management, management, or as employees of the organization, then their independence is impaired. Additionally, external auditors may provide the organization with other services such as tax and consulting. Independence needs to be assessed in relation to the full range of services provided to the organization.
9. To ascertain that the scope of work is adequate for the purposes of the internal audit activity, the CAE obtains sufficient information regarding the scope of the external service provider's work. It may be prudent to document these and other matters in an engagement letter or contract. To accomplish this, the CAE reviews the following with the external service provider:

- Objectives and scope of work including deliverables and time frames.
- Specific matters expected to be covered in the engagement communications.
- Access to relevant records, personnel, and physical properties.
- Information regarding assumptions and procedures to be employed.
- Ownership and custody of engagement working papers, if applicable.
- Confidentiality and restrictions on information obtained during the engagement.
- Where applicable, conformance with the Standards and the internal audit activity's standards for working practices.

(continued)

10. In **reviewing the work of an external service provider**, the CAE evaluates the adequacy of work performed, which includes sufficiency of information obtained to afford a reasonable basis for the conclusions reached and the resolution of exceptions or other unusual matters.
11. **When the CAE issues engagement communications, and an external service provider was used, the CAE may, as appropriate, refer to such services provided**. The external service provider needs to be informed and, if appropriate, concurrence should be obtained before making such reference in engagement communications.

Question 10: 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 11: When an engagement is assigned, management asks 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)

Answers to Questions

1 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.

2 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.

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

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

5 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.

6 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.

7 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.

8 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.

9 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 (for example, economics, or statistics) 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.

10 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.

11 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.

12 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.

13 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.

14 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.

15 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.

16 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.

17 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.

18 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.

19 a – Directive controls are controls that are in place in an attempt to ensure the achievement of a goal. A control that is designed to provide management with the assurance of the realization of an objective is therefore a directive control.

