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Sample

Internal Audit Practice

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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.

Topic I B. Operational Role of Internal Audit

The operational role of internal auditing is to make sure that engagements have been properly planned for, that the IAA has the resources (human and financial) to carry out the engagements, and that the results of the engagements are communicated to those who can take action. The CAE must effectively manage the IAA so that management and the board will regard all of these functions as value-added activities.

The following section discusses the role of internal auditing within the organization's risk management framework.

B1. Developing Policies and Procedures

Standard 2040: Policies and Procedures

The chief audit executive must establish policies and procedures to guide the internal audit activity.

Another duty of the CAE is to establish the policies and procedures to guide the IAA and the individual internal auditors in their work. These policies and procedures are essential in helping the staff comply with the IAA's standards of performance. The extent, depth, and formalization of the policies and procedures will depend upon the size and structure of the IAA and the complexity of its work. In a small IAA with a simple business structure, policies and procedures will be less developed and less formal than those in a multinational business in a very complex business environment.

A small IAA is managed much more informally with a lot of personal and daily contact. Control may take place through meetings and internal memorandum. In a large IAA, where contact with the managers may not be constant, there will need to be a more formal set of policies and procedures to guide staff in their day-to-day work.

Question 9: Policies and procedures relative to managing the internal audit activity should

a) Ensure compliance with its performance standards.

b) Give consideration to its structure and the complexity of the work performed.

c) Result in consistent job performance.

d) Prescribe the format and distribution of engagement communications and the classification of engagement observations.

(CIA Adapted)

Question 10: In most cases, an internal audit activity should document policies and procedures to ensure the consistency and quality of its work. The exception to this principle is directly related to:

a) Departmentation

b) Division of labor

c) Size of the internal audit activity

d) Authority

(CIA Adapted)

Planning

Standard 2010: Planning

The chief audit executive must establish risk-based plans to determine the priorities of the internal audit activity and to make certain that they are consistent with the organization's goals.

When prioritizing risk, the CAE takes into consideration the company's risk-management framework, including the levels of risk appetite that management sets for different parts of the organization. If management has not yet developed a risk-management framework, the CAE will use his or her own judgment of risks after consulting with senior management and the board.

This much larger, overall planning process is broken down into four smaller categories that the CAE is responsible for:

- Goals
- Engagement work schedules
- Staffing plans and financial budgets
- Activity reports

Setting the Goals of the Internal Audit Activity

Note: For memorization purposes, the five goals of the IAA form the acronym SMART.

The goals that the IAA sets should be:

- **S**pecific: Goals should be specifically defined.
- **M**easurable: The method of measuring the goals should be defined. By making goals measurable, the CAE, the audit committee, and board of directors can progress toward achieving specific goals—and by extension they can quantify the value of the IAA.
- **A**greed To: All interested parties (including senior management and the board) need to agree to the goals.
- **R**ealistic and Achievable: Realistic and achievable goals keep expectations reasonable; conversely, unrealistic and unachievable goals create unnecessary tension in an organization.
- **T**imely: Goals should have specific completion dates, because open-ended timeframes reduce the sense of urgency about objectives.

B2. Review the Role of Internal Audit in the Risk Management Process

Standard 2120: Risk Management

The internal audit activity must evaluate the effectiveness and contribute to the improvement of risk management processes.

Risk management is a key responsibility of management, but the internal auditor plays a role in this process. Internal auditors, acting in a consulting role, can assist both management and the audit committee by examining, evaluating, reporting, and recommending improvements to the adequacy and effectiveness of management's risk processes. It is with the guidance of the internal auditor's findings that senior management and the board can then oversee the organization's risk management and control processes.

The assessment and reporting of an organization's risk management processes are normally a high audit priority, and the charter should clearly outline management and the board's expectations for the IAA. The IAA's role in risk management is likely to be determined by such factors as the culture of the organization, the skill-set of the internal audit staff, and local conditions and customs of the host country in which the audit takes place.

Internal auditors should address any risk exposures that they encounter in any engagement and evaluate them further as necessary, even if it is not part of the immediate engagement.

It is important to remember that the IAA's role in the risk management process is not static and could possibly change over time. PA 2120-1 (*Assessing the Adequacy of Risk Management Processes)* provides a list of four different roles that the internal audit activity can be in the risk management process.

PA 2120-1: Assessing the Adequacy of Risk Management Processes

4. The CAE is to obtain an understanding of senior management's and the board's expectations of the internal audit activity in the organization's risk management process. This understanding is then codified in the charters of the internal audit activity and the board. Internal auditing's responsibilities are to be coordinated between all groups and individuals within the organization's risk management process. The internal audit activity's role in the risk management process of an organization can change over time and may encompass:

- No role.
- Auditing the risk management process as part of the internal audit plan.
- Active, continuous support and involvement in the risk management process such as participation on oversight committees, monitoring activities, and status reporting.
- Managing and coordinating the risk management process.

Ultimately, senior management and the board decide the internal auditor's specific level of involvement in the risk management process.

PA 2120-1: Assessing the Adequacy of Risk Management Processes

5. Ultimately, it is the role of senior management and the board to determine the role of internal auditing in the risk management process. Their view on internal auditing's role is likely to be determined by factors such as the culture of the organization, ability of the internal audit staff, and local conditions and customs of the country. However, taking on management's responsibility regarding the risk management process and the potential threat to the internal audit activity's independence requires a full discussion and board approval.

Assessing the Adequacy of Risk Management Processes

Standard 2120.A1

The internal audit activity must evaluate risk exposures relating to the organization's governance, operations, and information systems regarding the:

- Achievement of the organization's strategic objectives.
- Reliability and integrity of financial and operational information.
- Effectiveness and efficiency of operations and programs.
- Safeguarding of assets.
- Compliance with laws, regulations, policies, procedures, and contracts.

Every organization will have its own particular methodology to implement the risk management process, and so the internal auditor's job is to determine whether or not the methodology is clearly understood by the key groups, including the board and audit committee. Therefore, the internal auditor must be satisfied that the organization's risk management processes address these five key objectives:

1) Risks that arise from business strategies and activities must be identified and prioritized.

2) Management and the board must determine the level of risk acceptable to the organization (that is, an assessment of risk appetite).

3) Risk mitigation (reduction) activities must be designed and implemented to reduce or otherwise manage risk at acceptable levels.

4) Risk must be periodically reassessed on an ongoing basis.

5) Reports must be given periodically to the board and management on the results of the risk assessment process.

The IAA needs to assess these five objectives in order to ascertain the adequacy of the risk management processes, which is addressed in all engagements. The auditors need to look vigilantly for signs that might indicate a problem or a cause for concern related to risk management.

During the process of gathering evidence on which it will base its conclusion, various procedures will be performed. PA 2120-1: Assessing the Adequacy of Risk Management Processes provides a list of procedures that the internal auditor should consider:

1. Research and review current developments, trends, industry information related to the business conducted by the organization, and other appropriate sources of information to determine risks and exposures that may affect the organization and related control procedures used to address, monitor, and reassess those risks.

2. Review corporate policies and board minutes to determine the organization's business strategies, risk management philosophy and methodology, appetite for risk, and acceptance of risks.

3. Review previous risk evaluation reports issued by management, internal auditors, external auditors, and any other sources.

4. Conduct interviews with line and senior management to determine business unit objectives, related risks, and management's risk mitigation and control monitoring activities.

5. Assimilate information to independently evaluate the effectiveness of risk mitigation, monitoring, and communication of risks and associated control activities.

6. Assess the appropriateness of reporting lines for risk monitoring activities.

7. Review the adequacy and timeliness of reporting on risk management results.

8. Review the completeness of management's risk analysis and actions taken to remedy issues raised by risk management processes, and suggest improvements.

9. Determine the effectiveness of management's self-assessment processes through observations, direct tests of control and monitoring procedures, testing the accuracy of information used in monitoring activities, and other appropriate techniques.

10. Review risk-related issues that may indicate weakness in risk management practices and, as appropriate, discuss with senior management and the board. If the auditor believes that management has accepted a level of risk that is inconsistent with the organization's risk management strategy and policies, or that is deemed unacceptable to the organization, refer to Standard 2600 and related guidance for additional direction.

The assessment of risk is, unfortunately, not always something that can be put into a formula and easily measured. The successful assessment of risk often rests with the professional judgment and experience of the internal auditors and the CAE.

The risk management processes that are actually implemented will differ from organization to organization and will be influenced by the nature of the business, the size of the business, and the complexity of their operations. These risk management processes can be:

- Formal or informal.
- Quantitative or subjective.
- Embedded in the business units or centralized at the corporate level.

The specific process that the organization uses will depend on its culture, management style, and business objectives. For example, the use of derivatives or other sophisticated capital market products would require the use of quantitative risk management tools. Smaller, less complex organizations may use an informal risk committee to discuss the organization's risk profile and to initiate periodic actions. The auditor should determine if the chosen methodology is both comprehensive and appropriate for the nature of the organization's activities.

Question 11: Which of the following does not address a key objective of the risk management process?

a) Risks that arise from business strategies are identified and prioritized.

b) Risk mitigation (reduction) activities are designed and implemented to reduce, or manage, risk at levels that are acceptable.

c) Review of previous risk evaluation reports by management, external auditors, and other sources.

d) Risk is periodically reassessed on an ongoing basis.

(HOCK)

Assessing the Adequacy of Risk Management Processes for Formal Consulting Services

By providing consulting services, the internal auditor adds value to the organization's operations. For example, internal auditing might be asked to assist, establish, or improve risk management processes. Internal auditors should be proactive, particularly when it comes to risk management, but consulting engagement must not impair the auditor's independence or objectivity.

Note: A **consulting service** is defined as advisory and related client-service activities, the nature and scope of which are agreed upon with the client. They are intended to add value and improve an organization's governance, risk management, and control processes without the internal auditor assuming management responsibility. Examples: counsel, advice, facilitation, and training.

Concerning risk management, internal auditors must utilize knowledge gained from consulting engagements to identify and evaluate significant risk exposures. If auditors identify significant risk exposure or control weaknesses, management must be alerted. It some cases, particularly where there are significant risk exposures, it might be necessary for the internal auditor to communicate directly with the board or audit committee.

As with any assessment engagement, the internal auditor should use professional judgment to

- Determine the significance of exposures or weaknesses and the actions taken or contemplated to mitigate or otherwise correct these exposures or weaknesses.
- Ascertain the expectations of management, the audit committee, and board in having these matters reported.

Internal auditors need to avoid managing risks during a consulting engagement (Standard 2120.C3) because doing so might result in a negative outcome, which could be perceived as an internal auditing failure and irreparably damage the reputation of the IAA.

Managing the Risk of the Internal Audit Activity

There is tremendous pressure on internal auditing to identify, assess, and recommend ways to mitigate financial, operational, information technology, legal, regulatory, compliance, and strategic risks. However, internal auditing departments often have difficulty finding and retaining qualified personnel. In some cases, this can prevent the IAA from achieving its objectives, which in itself is also a risk. Therefore, the CAE needs to be constantly looking for ways that the IAA can manage its own risk.

Practice Advisory 2120-2 (*Managing the Risk of the Internal Audit Activity*) has identified three distinct risks faced by internal auditing:

1) Audit failure
2) False assurance
3) Reputation risk

1) Audit Failure Risk

Any one or more of the following factors can result in audit failure:

- Not following the *International Standards for the Professional Practice of Internal Auditing*
- Failure to design effective internal audit procedures to test "real" risks
- Failure to evaluate both design adequacy and control effectiveness as part of internal audit procedures
- Failure to exercise heightened professional skepticism and extended internal audit procedures related to findings or control deficiencies
- Inexperienced and unskilled audit staff members
- Failure to provide adequate supervision
- Making the wrong decision when there was evidence of fraud (for example, saying that "it wasn't material" or "there were not the resources to deal with the issue")
- Failure to properly communicate suspicions to the right people
- Failure to report adequately

While no one can guarantee that audit failure will never occur, the IAA can manage these risks in the following ways:

- Making sure there is a QAIP (for example, follow Standard 1300)
- Reviewing the company's risk profile to make sure that the audit universe is complete
- Making sure there is proper audit planning
- Making sure there is effective audit design (for example, determining the adequacy of internal controls prior to the start of testing)
- Executing proper resource allocation (for example, making sure that the appropriate staff is assigned to the engagement)
- Engaging in effective management review, meaning that there is proper internal audit supervision of the internal audit process (for example, reviewing working papers)

2) False Assurance

On the one hand, management and the board usually have high expectations regarding the level of assurance that the IAA can provide. It may seem reasonable to them to assume that the mathematical precision of auditing always leads to solid, unquestionable conclusions. On the other hand, there are clearly limits as to how much assurance the IAA can actually provide, keeping in mind the numerous variables and unpredictable elements involved. The distance between these two perspectives is called the "**expectation gap,**" and it constantly surrounds the work that the IAA performs.

To bridge the divide created by this "expectation gap," the IAA can proactively manage the risk of false assurance. Frequent and clear communication with the audit committee, management, and other key stakeholders is an essential part of reducing the potential for false assurance. The more that management and the board become aware of the nuances and contingencies associated with internal auditing, the more realistic their expectations become. Conversely, the more that the internal auditor understands about the thinking process of management and the board, the more effective he or she will be in addressing their concerns.

3) Reputation Risk

Through years of consistent, high-quality work, an internal auditor can steadily build a reputation for the integrity of the IAA within a given company. A solid reputation is vital to the ongoing work of the IAA because management and the board must believe that they can trust in its findings to make appropriate decisions for the health and success of the company. However, underlying all the good that internal auditing provides is reputation risk, the danger that a single, critical failure might wipe out years of accumulated faith and goodwill. In the case of IAA, it only takes one poorly executed internal audit, a string of significant financial restatements, or one regulatory investigation to undermine the IAA's standing. At a minimum, such an event or events might cast suspicion on the future effectiveness of the IAA. At worst, a company might seek to eliminate the IAA altogether.

If the IAA is responsible for an event that damages its reputation within the organization (and by extension the public reputation of the organization itself), it is vital that the CAE immediately intervene, review the root causes, and make all necessary changes to the system. Under certain circumstances, reprimands and/or dismissals may be required. Without such a forceful response, or if corrections are delayed, the IAA's reputation may be so impaired that it will take years to recover, if ever. Conversely, swift, effective, corrective action can restore a reputation, if not to its full standing then at least to a state where trust can be quickly regained.

The following information is for the next two questions.

The internal auditors of a financial institution are evaluating the institution's investing and lending activities. During the last year, the institution has adopted new policies and procedures for monitoring investments and the loan portfolio. The internal auditors know that the organization has invested in new types of financial instruments during the year and is heavily involved in the use of financial derivatives to hedge risks appropriately.

Question 12: The internal auditors are evaluating the adequacy of the new policies and procedures in maintaining an appropriate risk profile. Which of the following engagement procedures is least relevant to the accomplishment of the engagement objective?

a) Meet with operational management to determine its interpretation of any procedures that are not clear.

b) Meet with senior management or a board member, if necessary, to clarify policy issues.

c) Test a sample of investments for compliance with the new procedures.

d) Review recent regulatory pronouncements to determine whether the new procedures are consistent with regulatory requirements.

Question 13: The audit committee has expressed concern that the financial institution has been taking on higher-risk loans in pursuit of short-term profit goals. Which of the following engagement procedures provides the least amount of information to address this concern?

a) Perform an analytical review of interest income as a percentage of the investment portfolio in comparison with a group of peer financial institutions.

b) Take a random sample of loans made during the period and compare the riskiness of the loans with that of a random sample of loans made 2 years ago.

c) Perform an analytical review that involves developing a chart to compare interest income plotted over the past 10 years.

d) Develop a multiple-regression time-series analysis of income over the past 5 years, including such factors as interest rate in the economy, size of loan portfolio, and dollar amount of new loans each year.

(CIA Adapted)

Question 14: When the executive management of an organization decided to form a team to investigate the adoption of an activity-based costing (ABC) system, an internal auditor was assigned to the team. The best reason doing this is the internal auditor's knowledge of:

a) Activities and cost drivers.

b) Information processing procedures.

c) Current product cost structures.

d) Risk management processes.

(CIA Adapted)

B3. Direct Administrative Activities

The administrative activities of the internal audit activity will be wide and varied. It is not expected that the CAE will carry out these administrative duties personally, but there must be a mechanism of oversight in place. One of the most important administrative duties is connected to human resources within the internal audit activity. There must be plans and procedures in place to ensure that the proper, qualified, required staff are hired and that their work schedules are managed to get maximum efficiency and effectiveness from the personnel.

Developing the Engagement Work Schedules

The planning process and specific work schedules for engagements should include the following:

- **Which** engagements should be performed
- **When** engagements should be performed
- The **time required** for each engagement (taking into account the scope of the planned engagement work and the nature and extent of related work performed by others)
- Which engagements should receive **priority** over other engagements

Once these questions are answered, the CAE can develop individual work programs for specific engagements.

Managing Resources

Standard 2030: Resource Management

The chief audit executive must ensure that internal audit resources are appropriate, sufficient, and effectively deployed to achieve the approved plan.

Standard 2030 states that internal audit resources must be "appropriate, sufficient, and effectively deployed." **Appropriate** means having the right mix of staff with the appropriate competencies to perform the plan. **Sufficient** means having the right quantity of staff to accomplish the plan. Internal audit resources are **effectively allocated** if they are used in a way that optimizes the achievement of the approved plan.

The CAE needs to oversee the assignment of individual staff to the engagements with both a short-term and long-term view. In the short term, all of the jobs need to be staffed by qualified and capable internal auditors so that the job can be completed to the highest level. In the long term, however, the staff needs to be assigned to jobs that will allow them to grow and become more senior auditors.

This long-term view requires occasionally assigning jobs to staff members who may not currently have all of the necessary skills and experience. Under such circumstances, the CAE needs to make sure that a skilled supervisor can provide the needed support and guidance to the junior member of the team. Also, training can be provided or additional resources can be made available to that auditor to assist in this process.

Some factors to consider when assigning staff to individual engagements are:

- The complexity of the engagement
- The resources that are available in the IAA
- The experience (skill level) of the staff
- The training and developmental needs of the audit staff

Recruiting and Promoting

The CAE needs to coordinate with human resources in order to be involved in recruiting and retaining qualified audit staff. The most important criteria in hiring is the education and experience of the candidate. The individual needs to have the technical skills or background to do the job. This does not mean that everyone who is hired needs to be a CIA, but there should be some indication that candidates will be able to do the job based on their formal education or by experience in a previous position that is related to what needs to be done. Not everyone in the IAA needs to be a trained or qualified accountant, because there are many engagements that are not related to accounting or financial statements.

The ability of the candidate to communicate, both in written and verbal forms, and the individual's overall interpersonal skills should also be considered. These are critical elements of the IAA because an ineffective communicator is a much less effective internal auditor regardless of their technical skills.

Once the staff has been hired, the next HR issue relates to staff promotion and filling higher-level positions in the IAA. When a higher-level position becomes available, the CAE has two basic options for filling it: either the CAE can fill the opening with someone from inside the company or he or she can look outside the organization.

Hiring from **inside the organization** can be done quickly and with less "start-up" time for the person who gets the position, because the employee is already familiar with the policies and procedures and the environment of the organization. Also, there is less risk because the CAE has already worked with the individual and is more aware of what the individual can and cannot do. Hiring from within the organization is also generally a good motivating factor for others in the IAA because they know that good work will be rewarded with promotion. If, however, the wrong people are promoted, or people are promoted because of reasons other than their work skills, then promotion may have a negative effect on the others in the department.

Hiring someone from **outside the organization** is riskier, but it also has its advantages. For example:

- The outside person could bring new ideas and new perspectives to the job and the organization.
- It is possible that the person may have skills or experiences that are not within the organization.
- It is also possible that that management training costs could be lowered because it is assumed that the person is already qualified and will not require additional training.

Job Descriptions

An important basis for the recruitment and promotion of staff is the job description. Job descriptions should be established for all positions, listing the **necessary skills and requirements for the position**. Accurate, concise job descriptions and a strict adherence to hiring guidelines makes the recruitment process smooth and easy because all potential candidates know what is required to be promoted and that only qualified people will be hired for the jobs.

With detailed and complete job descriptions, the CAE has an easier time determining if the IAA is properly staffed. If the people in all of the positions have the necessary skills as outlined in the job description, then the function is properly staffed. If, however, there are some people without the necessary skills in some positions, there is a missing element in the IAA, which will need to be addressed either through training or the addition of someone to the IAA with those skills.

Training, Staff Development, and Performance Evaluations

The CAE is also responsible for the training, counseling, and performance evaluations of the staff. Training needs to be provided with the goal of giving the staff the necessary skills to perform their jobs in the short term and also to develop and broaden their skills for their long-term development. Individuals often see training as a benefit, and a well-developed training program is an excellent recruiting tool for the company. Training should benefit the individual and also help the IAA meet its organizational goals. Therefore, some staff may be trained in areas where the IAA does not currently have all of the required skills, even if the staff don't have a personal interest in those areas.

Counseling, or **mentoring**, is an important element of staff development. The CAE has a responsibility for counseling and assisting staff members in their growth in the organization. This is not to say that the CAE is supposed to have weekly counseling sessions with each of their staff, but the CAE has a responsibility to step in as needed. In a large internal audit department, there may be a formal counseling and mentoring program and, in such a situation, the CAE most likely is responsible for the oversight and management of the process. Additionally, the CAE may be the counselor for some of the higher-level staff members in the department.

Performance evaluations should be performed at least annually, or more often if needed. The performance evaluations need to focus on the skills that are necessary for the individual to perform his or her work and for IAA as a whole to perform its duties. These staff evaluations should be seen as a means of giving internal audit employees the opportunity to identify their weaknesses and give them an opportunity to improve their performance. The evaluation should not be based on personal likes or dislikes or other non-employment related factors, especially when the evaluation is an engagement evaluation of work on a specific assignment and not an annual evaluation.

There should be sufficient time to allow everyone to prepare for the annual evaluation. This usually involves the auditor and the manager both filling out the evaluation form and preparing for the meeting. The meeting should be scheduled when both parties are not pressed for time so that anything that arises during the evaluation can be discussed and addressed without one person trying to hurry through the evaluation because of other commitments.

The performance evaluation form can be a standard form, which focuses the evaluation on the most important areas. However, for the process to work as well as possible, the evaluation needs to be carefully thought through by the evaluator and should not include over-general comments that are applicable to everyone. Examples and specific references to events should be included in order to make the evaluation as detailed as possible.

Question 15: An important part of an internal audit activity's personnel development plan should be on-the-job training. Which of the following activities is the most important in broadening a staff internal auditor's knowledge?

a) Rotating staff internal auditors through a variety of assignments.

b) Developing expertise in a few particular areas by continuously assigning the same internal auditor to those areas.

c) Allowing staff internal auditors to participate in choosing the projects assigned.

d) Assigning staff internal auditors to particular supervisor-trainers for extended periods.

(CIA Adapted)

Question 16: The chief audit executive can best ensure that staff internal auditors are prepared to meet their existing responsibilities by

a) Enforcing established recruiting and selection criteria.

b) Counseling them on their performance and providing appropriate training opportunities.

c) Having experienced internal auditors supervise their work closely.

d) Conducting formal evaluations of their performance on each assignment.

(CIA Adapted)

B4. Interviewing Candidates for Internal Audit Positions

As part of the hiring process, a number of members of the internal audit staff may be involved in interviewing candidates. While many of the interviewing techniques that are used in interviewing during engagements are applicable to an employment interview, the auditor must keep in mind that they are assessing a candidate to work in the department.

The interview process may involve a number of different interviews. It is common for the first interview to be a shorter interview conducted by the HR department (if one exists) in order to assess whether the candidate meets the minimum requirements for the position. There may also be some standardized tests that are given to all applicants in the company.

This may be followed by a couple of interviews with internal audit managers and/or staff. If these interviews are completed satisfactorily, the CAE will usually conduct the final interview. This final interview will allow the CAE to make a final decision as well as follow up on any areas of concern identified during the earlier interviews.

Throughout the interview process, the interviewer needs to asses a number of areas about the candidate. Among them are:

- Does the candidate have the necessary skills for the position? (The necessary skills will depend on the level of the position and the expected duties, but they should be outlined in the job description.)
- Does the candidate have the required experience and/or education?
- How will the candidate fit in with the internal audit department and also the corporate culture as a whole?

As part of the interview process, the candidate may be presented with work-related situations and asked how they would respond, or what would be an appropriate course of action. While it would be ideal to watch the candidate in actual work situations, that is usually not possible so the interviewer will need to recreate work situations as best they can in the interview setting.

B5 – 6. Reporting on Effectiveness to Senior Management and Board

Standard 2060: Reporting to Senior Management and the Board

The CAE must report periodically to senior management and the board on the internal audit activity's purpose, authority, responsibility, and performance relative to its plan. Reporting must also include significant risk exposures and control issues, including fraud risks, governance issues, and other matters needed or requested by senior management and the board.

The frequency of reporting to the Board by the CAE depends on the importance of the information and the urgency of the related actions that senior management or the board should take. There are two types of reports that the CAE will submit to senior management and the board: one communicates what the IAA accomplished ("activity reports") and the other communicates what the IAA has observed ("evaluation reports"). We will look at activity reports and evaluation reports in more detail later in this section.

Two specific areas of reporting that the CAE needs to report to the Board on are:

1) Report on the effectiveness of corporate risk management.

2) Report on the effectiveness of the internal control and risk management functions.

The assessment of the risk management process is covered under Topic B2. Periodically (at least once a year) the CAE should report to the Board.

In this reporting, the CAE needs to use the objectives of the company as a guide. The internal control framework and systems and the risk management process should be such that they will assist the company in achieving its objectives. Any weaknesses in these areas should be identified to the Board as appropriate and any correction actions should be provided as well.

Activity Reports

The CAE must submit activity reports to senior management and the board periodically. These reports should be done at least once a year, but more often if the volume or the nature of the work requires the closer involvement of the board. This may be the case if, for example, there are high-risk areas being audited and the board wants to be kept closely apprised of the progress.

Activity reports should:

- Be communicated, preferably in writing.
- Highlight significant engagement observations (that is, observations that may have an adverse effect on the organization as a whole).

  Note: These observations and the following recommendations are normally discussed first with the involved department, and any corrective action or improvements that have occurred will also be included in the activity report to the board.

- Identify recommendations that have arisen from the engagements.
- Compare the engagements that were planned with those that were completed. (Any reasons for which a planned engagement was not performed should be discussed.)
- Compare actual performance with the internal audit activity's goals and audit work schedules.
- Compare expenditures to financial budgets. (Reports should explain the reason for major variances and indicate any action taken or needed.)

Note: The activity report should be delivered to the board or other recipients before a meeting so that they can fully review its contents before discussing it.

Because the activity reports should be a summary of accomplishments, the CAE should guard against preparing an overly detailed report, such as one that lists every internal audit department activity.

Significant Engagement Observations

Significant engagement observations are those conditions that, in the judgment of the CAE, could adversely affect the organization, such as irregularities, illegal acts, errors, inefficiency, waste, ineffectiveness, conflicts of interest, and control weaknesses. After reviewing such conditions with senior management, the CAE should communicate significant engagement observations and recommendations to the board, including whether or not they have been satisfactorily resolved.

Management Responsibility for Significant Engagement Observations

The internal auditor should only provide information and alternative courses of action. Although the internal auditor may also make a recommendation, he or she should not make any final decisions. Management is responsible for deciding appropriate actions related to significant engagement observations and recommendations. For example, senior management might decide to assume the risk of not correcting the reported condition because of cost or other considerations. Whatever the circumstances, the board should be informed of senior management's decisions on all significant observations and recommendations.

CAE Considerations on Reporting Significant Engagement Observations

The CAE should consider the appropriateness of informing the board of previously reported, significant observations and recommendations in those instances where senior management and the board assumed the risk of not correcting the reported condition. If the board is aware of the risks and has decided against addressing them, the item probably does not need to be reported each year. However, if there have been significant changes in the organization, board, or senior management, the items should probably be reported again so that the new management can determine its preferred course of action.

Relationship with Audit Committee

Sound governance depends on the synergy generated among the four principal components of effective corporate governance systems:

- Boards of directors
- Management
- Internal auditors
- External auditors

Within this structure, internal auditors and audit committees are mutually supportive. The internal auditors are the trusted advisors, the "eyes and ears" of the audit committees, and thus the relationship between the CAE and audit committee centers on the core role of the CAE, which is to ensure that the committee understands, supports, and receives all needed assistance from the internal audit function.

Three areas of CAE activities are key to the success of the interrelationship between board, management, internal auditors, and external auditors. The CAE activities should:

1) Assist the audit committee to ensure that its charter, activities, and processes are appropriate to fulfill its responsibilities.

2) Ensure that the charter, role, and activities of internal audit are clearly understood and responsive to the needs of the audit committee and the board.

3) Maintain open, effective communications with the audit committee and the chairperson.

Assisting the Audit Committee

The CAE should assist the audit committee to ensure that the charter, role, and activities of the **audit committee** are appropriate and that it can fulfill its responsibilities. The CAE can also help the audit committee periodically review its activities and suggest improvements. The following is a list of ways in which the CAE can be of service to the audit committee:

- Review the audit-committee charter at least once a year, advise the committee as to whether the charter addresses all responsibilities that the board of directors charged them with, and request that the committee review and approve the internal audit charter on an annual basis.
- Review or maintain a planning agenda for the audit committee's meeting that details all required activities and their status or results, which helps the committee report to the board that it has completed all assigned duties.
- Draft the audit committee's meeting agenda for the chairman's review, facilitate the distribution of the material to the audit committee members, and record the minutes of the audit committee meetings.
- Encourage the audit committee to conduct periodic reviews of its activities and practices compared with current "best practices."
- Meet with the chairperson to discuss whether or not the materials and information furnished to the committee are meeting their needs.
- Ask if the audit committee requires any educational or informational sessions.
- Determine whether the frequency of meetings and time allotted to the committee are sufficient.

Communication with the Audit Committee

Internal auditing can help bring a systematic, disciplined approach to audit committee activities. However, the overall effectiveness of the relationship between the CAE and audit committee depends on clear lines of communication. Therefore, for the CAE to be a trustworthy advisor, he or she must be a skillful communicator.

Effective communication between the CAE and the audit committee can be developed in the following ways:

- Meeting privately with the committee on a regular basis to discuss sensitive issues.
- Providing an annual summary report or assessment on the results of the audit activities relating to the defined mission and scope of audit work.
- Issuing periodic reports to the audit committee and management summarizing results of audit activities.
- Keeping the audit committee informed of emerging trends and successful practices in internal auditing.
- Together with external auditors, discussing the fulfillment of committee information needs.
- Reviewing information submitted to the audit committee for completeness and accuracy.
- Confirming an effective, efficient coordination of activities between internal and external auditors and determining any duplication between the work of the internal and external auditors (and giving the reasons for such duplication).

Question 17: A CAE activity report should not

a) List the material engagement observations of major engagements.

b) Compare engagements completed with engagements planned.

c) List uncorrected reported conditions.

d) Report the weekly activities of the individual internal auditors.

(CIA Adapted)

Question 18: An annual summary report of completed engagement work submitted to senior management and the board by the Chief Audit Executive should

a) Discuss the administrative condition of the internal audit activity.

b) Inform management of the scope of proposed work for the following year.

c) Describe the extent to which the internal audit activity has completed its engagement schedule.

d) Emphasize the number of deficiency observations discovered by the internal auditors.

(CIA Adapted)

Question 19: Which of the following audit committee activities is of the greatest benefit to the internal audit activity?

a) Review and approval of engagement work programs.

b) Assurance that the external auditor will rely on the work of the internal audit activity whenever possible.

c) Review and endorsement of all internal auditing engagement communications prior to their release.

d) Support for appropriate monitoring of the disposition of recommendations made by the internal audit activity.

(CIA Adapted)

Question 20: The internal audit activity customarily has a dual relationship with management and the audit committee. This means that:

a) Management should help the internal audit activity by revising and forwarding engagement communications to the audit committee.

b) The internal audit activity should report directly to the audit committee, without corroborating engagement communications with management.

c) The accuracy of engagement communications should be verified with management, and the internal audit activity should then report to management and the audit committee.

d) Ideally, the internal audit activity works under the audit committee but reports to the Chief Operating Officer on all engagements relating to operations.

(CIA Adapted)

B7. Maintain an Effective Quality Assurance and Improvement Program

Note: The topic of the Quality Assurance and Improvement Program (QAIP) is also tested on the Part 1 Exam. The materials presented here are the same as in the Part 1 Textbook. If you have already studied Part 1, we still recommend that you review this material, even though it is already familiar to you.

Note: Because of the very large Practice Advisories for this topic, the full text of these are presented in Appendix B. The full text of the Standards and excerpts of the Practice Advisories will be included here as needed.

Another important function of the CAE is to assure the quality of the work performed by the internal audit activity. This assurance is done by establishing a **quality assurance and improvement program (QAIP)**. The QAIP is designed to evaluate wither or not the work of the IAA is in conformance with the definition of internal auditing and the *Standards* and the Code of Ethics. The QAIP also enables the assessment of the efficiency and effectiveness of the IAA and can also identify areas for improvement.

As we will see, the QAIP includes both **internal** and **external quality assessments** and also **periodic and ongoing assessments**. Each part of the program is designed to help the IAA add value to the organization, improve the organization's operations, and provide assurance that the internal audit activity conforms to the Definition of Internal Auditing and the *Standards*.

Standard 1300: Quality Assurance and Improvement Program

The chief audit executive must develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity.

Interpretation:

A quality assurance and improvement program is **designed to enable an evaluation of the internal audit activity's conformance with the Definition of Internal Auditing and the Standards and an evaluation of whether internal auditors apply the Code of Ethics**. The program also assesses the **efficiency** and **effectiveness** of the internal audit activity and identifies opportunities for improvement.

QAIP assessments should include evaluations of:

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

The results of these assessments are provided to the stakeholders of the activity (such as senior management, the board, and external auditors). At least once a year the CAE should report to senior management and the board the results of internal assessments on the efforts and results of the QAIP.

Defining Quality

A common issue that arises with quality program assessments is that "quality" can mean different things to different people. This potential discrepancy is particularly true of service operations such as the internal audit activity. For example, the internal audit department may be conforming to the *Standards*, but such adherence does not necessarily mean that an organization is operating in an effective or efficient manner. To resolve this potential problem, organizations develop **quality circles**.

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

Quality circles frequently use benchmarking as a means to improve quality and productivity. **Benchmarking** is the process of a company using the standards set by other companies as a target or model for its own operations. (This is also called **best practices**.) In other words, benchmarking (or best practices) is the process of continuously trying to emulate the best companies in the world. By striving to meet the standards of the best companies, an organization may be able to create a **competitive advantage** by achieving a higher standard than its competitors. Benchmarking can use both financial (such as with profit margins) and nonfinancial (such as the percentage of units produced that are defective).

The benchmark company does not necessarily need to be in the same industry as the company that is striving to raise its standards. If the desired function is the same across multiple industries, then the best company should be used as the benchmark.

Requirements of the QAIP

Standard 1310 – Requirements of the Quality Assurance and Improvement Program

The quality assurance and improvement program **must include both internal and external assessments**.

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

These internal and external assessments reassure the company stakeholders (that is, top management, audit committee, and external auditors) about the competency of the services the IAA is providing to the organization. In addition, these assessments can provide a way for the CAE to identify opportunities for improving the operational effectiveness and efficiency of the IAA.

We will look in more detail at internal and external assessment with each applicable *Standard*.

1. Internal Assessments (Standard 1311)

As the name implies, internal assessments will be performed by the internal auditors in the IAA.

The internal audit assessment must include two types of assessments. These are:

1) An **ongoing internal assessment** of performance of the internal audit activity.

2) A **periodic internal assessment** of the program through self-assessment or from an independent person within the organization who is familiar with the internal auditing program.

We will look at both of these in greater detail below.

Note: The cost of an internal review will be lower than an external review, but the CAE must be cautious because the internal review may not be quite as rigorous as it could be because people inside the organization are involved. Fortunately, in Practice Advisory 1311-1 there is guidance about how the internal assessments should be performed.

Standard 1311 – Internal Assessments

Internal assessments must include:

- **Ongoing monitoring** of the performance of the internal audit activity; and
- **Periodic self-assessments** or assessments by other persons within the organization with sufficient knowledge of internal audit practices.

Interpretation:

Ongoing monitoring is an **integral part of the day-to-day supervision, review, and measurement of the internal audit activity**. Ongoing monitoring is incorporated into the routine policies and practices used to manage the internal audit activity and uses processes, tools, and information considered necessary to evaluate conformance with the Definition of Internal Auditing, the Code of Ethics, and the Standards.

Periodic assessments are **conducted to evaluate conformance with the Definition of Internal Auditing, the Code of Ethics, and the Standards**.

Sufficient knowledge of internal audit practices requires at least an understanding of all elements of the International Professional Practices Framework.

The information in the following two bullet lists has been collected from PA 1311-1 (*Internal Assessments*).

Ongoing Internal Assessments are the conclusions and follow-up actions to assure that appropriate improvements are implemented. Ongoing reviews may be conducted through:

- Supervision of the internal auditor’s work during the course of the audit engagement
- Checklists, and other means, to provide assurance that processes adopted by the audit activity are being followed
- Peer review of workpapers by auditors not involved in the engagement
- Feedback from audit customers and other stakeholders
- Analyses of performance metrics (for example, cycle time and recommendations accepted)
- Project budgets, timekeeping systems, audit plan completion, cost recoveries, and so forth

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

- Include more in-depth interviews and surveys of stakeholder groups
- Be performed by members of the IAA (that is, self-assessment)
- Be performed by CIAs or other competent audit professionals currently assigned elsewhere in the organization
- Include self-assessment and preparation of materials subsequently reviewed by CIAs or other competent audit professionals from elsewhere in the organization
- Include benchmarking of the IAA practices and performance metrics against relevant best practices of the internal audit profession (“benchmarking” is discussed in greater detail below)

A key item to remember in respect to internal assessments is that they are done internally. This provides a number of advantages (for example, internal assessments are less expensive than external ones), but also has a potentially significant disadvantage that the internal audit function is reviewing itself. This disadvantage is overcome by having external assessments.

Note: An internal assessment that is performed soon before an external assessment can reduce the cost of the external assessment by allowing the IAA to identify and fix issues prior to the external assessment.

2. External Assessments (Standard 1312)

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

1312 - External Assessments

External assessments must be conducted at least once every five years **by a qualified, independent assessor or assessment team from outside the organization**. The chief audit executive must discuss with the board:

- The form and frequency of external assessment; and
- The qualifications and independence of the external assessor or assessment team, including any potential conflict of interest.

Interpretation:

External assessments can be in the form of a full external assessment, or a self-assessment with independent external validation.

A qualified assessor or assessment team demonstrates competence in two areas: **the professional practice of internal auditing and the external assessment process**. Competence can be demonstrated through a mixture of experience and theoretical learning. Experience gained in organizations of similar size, complexity, sector or industry, and technical issues is more valuable than less relevant experience. In the case of an assessment team, not all members of the team need to have all the competencies; it is the team as a whole that is qualified. The chief audit executive uses professional judgment when assessing whether an assessor or assessment team demonstrates sufficient competence to be qualified.

An independent assessor or assessment team means not having either a real or an apparent conflict of interest and not being a part of, or under the control of, the organization to which the internal audit activity belongs.

When the assessment is conducted from outside the organization, it is more independent and not as likely to be biased as an internally generated assessment. Of course, this advantage is offset by the higher cost of the assessment, and so the CAE must carefully decide on the merits of such a process.

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

During the review, an external assessor will tend to focus on:

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

Practice Advisory 1312-1 (*External Assessments*) lays out two approaches for conducting an external assessment:

1) Having a **full external assessment conducted by an external assessor** or **review team**.
2) Having an independent assessor or review team conduct an independent validation of the **internal self-assessment** and the corresponding report that was completed by the internal audit activity.

Ideally, a full external review is preferred, but there may be cases where this is simply not practical. Practice Advisory 1312-2 (*External Assessments: Self-assessment with Independent Validation*) gives some instances where a full external review might not be appropriate or necessary. For example:

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

1) External Assessments (PA 1312-1)

According to PA 1312-1 Paragraph 10, a full external assessment has a very broad scope of coverage of the areas of the IAA. It includes the following:

- Conformance with the Definition of Internal Auditing, the Standards, the Code of Ethics, the charter, plans, policies, procedures and practices
- Board and senior management expectations of the IAA
- The integration of the IAA into the organization's governance process, including relationships between key groups
- The skills and experience of the staff
- Determination if the IAA adds value and improves the organization's operation

The preliminary results of the assessment are discussed with the CAE and final results are communicated to the CAE, and perhaps additional officials who authorized the review to take place.

The communication includes:

- An opinion on the IIA's conformance with the Definition of Internal Auditing, the Code of Ethics, and the Standards
- An assessment and evaluation of the use of best practices
- Recommendations for improvement
- Response from the CAE that includes an action plan and implementation dates

The CAE must communicate the results of external quality assessments, including details of the planned actions for significant actions, to senior management, the board, and the external auditor. As planned actions are accomplished, this should also be communicated.

2) Self-Assessment with Independent Validation (PA 1312-2)

After the self-assessment has been completed under the direction of the CAE, a draft report, similar to that for an external assessment, is prepared. This draft report should include the CAE's assessment of the IAA's conformance with the *Standards*.

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

In essence, the independent validation is auditing the self-assessment to make certain that the conclusion reached in the self-assessment is correct.

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

- Review the draft report and attempt to reconcile unresolved issues, if any.
- If the external assessor agrees with the evaluation, he or she might include additional wording to the report as needed, concurring with the self-assessment process and opinion as well as the report's findings, conclusions, and recommendations.
- If the external assessor disagrees with the evaluation, he or she would add dissenting wording to the report, specifying the points of disagreement with it and, to the extent appropriate, with the significant findings, conclusions, recommendations, and opinions in the reports.
- Alternatively, the external assessor may prepare a separate independent validation report (concurring or expressing disagreement, as outlined above) to accompany the self-assessment report.

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

> **Note:** The individuals who perform the external assessment must be free from any conflicts of interest with the organization. It is the responsibility of the CAE to ensure that the individuals performing the external assessment are **qualified** and **independent**.

Standard 1320: Reporting on the Quality Assurance and Improvement Program

> **1320 – Reporting on the Quality Assurance and Improvement Program**
>
> **The chief audit executive must communicate the results of the quality assurance and improvement program to senior management and the board.**
>
> **Interpretation:**
>
> The form, content, and frequency of communicating the results of the quality assurance and improvement program is established through discussions with senior management and the board and considers the responsibilities of the internal audit activity and chief audit executive as contained in the internal audit charter. To demonstrate conformance with the Definition of Internal Auditing, the Code of Ethics, and the Standards, the results of external and periodic internal assessments are communicated upon completion of such assessments and the results of ongoing monitoring are communicated at least annually. The results include the assessor's or assessment team's evaluation with respect to the degree of conformance**.**

The QAIP analyzes the work of the IAA and makes recommendations for improvement, if appropriate. Because the CAE is in charge of the IAA, the CAE has the most to gain from the information contained in the assessment reports. Therefore, it is the CAE's responsibility to develop and maintain the QAIP for both external and internal assessments. Specific report functions are discussed below.

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

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

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

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

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

QAIP Comparison Table	**Internal Quality Assessment**	**External Quality Assessment**
Types of assessments	1) Ongoing monitoring of the performance of the internal audit activity 2) Periodic self-assessments	1) External Assessments 2) Self-assessment with Independent Validation
Form of report	At least annually, results of the internal assessments, necessary action plans, and their successful implementation are reported to senior management and the board	• Preliminary results discussed with CAE • Final report sent to Senior Management and Board • CAE must provide plan to address deficiencies
Performed by	Members of the IAA and supervised by the CAE.	• Qualified, independent professionals, or • Reviewers from outside the organization.
How often performed	• Ongoing assessments performed throughout the year. • Periodic assessments performed as needed.	At least once every 5 years.

Standard 1321: Conforming to the Standards of Internal Auditing

1321 – Use of "Conforms with the International Standards for the Professional Practice of Internal Auditing"

The chief audit executive may state that the internal audit activity conforms with the *International Standards for the Professional Practice of Internal Auditing* **only if the results of the quality assurance and improvement program support this statement**.

Interpretation:

The internal audit activity conforms with the Standards when it achieves the outcomes described in the Definition of Internal Auditing, Code of Ethics, and Standards. The results of the quality assurance and improvement program include the results of both internal and external assessments. All internal audit activities will have the results of internal assessments. Internal audit activities in existence for at least five years will also have the results of external assessments.

The CAE wants to be able to state that the internal audit activity conforms to the *International Standards for the Professional Practice of Internal Auditing*.

However, the CAE may use this statement only if assessments provide information that the IAA is in compliance. Providing information about compliance requires an external assessment at least once during a five-year period, along with periodic internal assessments. Both of these assessments have to conclude that the IAA conforms to the Definition of Internal Auditing, the Code of Ethics, and the *Standards*. It is expected that, before any use of the conformance statement, all instances of non-conformance will have been rectified.

Note: There are **only two phrases** that may be used to communicate compliance with the standards: "in conformance with the *Standards*" or "in conformity to the *Standards*." Other phrases may be similar, but these two are the only two that should be used.

Standard 1322: Disclosure of Noncompliance

1322 – Disclosure of Nonconformance

When nonconformance with the Definition of Internal Auditing, the Code of Ethics, or the *Standards* impacts the overall scope or operation of the internal audit activity, the chief audit executive must disclose the nonconformance and the impact to senior management and the board.

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

Question 21: The chief audit executive should develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity and continuously monitors its effectiveness. All of the following are included in a quality program except:

a) Annual appraisals of individual internal auditors' performance.

b) Periodic internal assessment.

c) Supervision.

d) Periodic external assessments.

(CIA Adapted)

Question 22: Formal internal quality assessments of the internal audit activity primarily serve the needs of

a) The board of directors.

b) The internal audit activity's staff.

c) The chief audit executive.

d) Senior management.

(CIA Adapted)

Question 23: As a part of a quality program, internal assessment teams most likely will examine which of the following to evaluate the quality of engagement planning and documentation for individual engagements?

a) Project assignment documentation.

b) Weekly status reports.

c) The long-range engagement work schedule.

d) Written engagement work programs.

(CIA Adapted)

Question 24: Which of the following is the best means of aiding an internal audit activity in determining whether its goals are being met?

a) Having the board periodically review the quality of the internal audit activity's work.

b) Developing measurement criteria to accompany its goals.

c) Scheduling an external assessment every three years.

d) Having external auditors review and evaluate the work of the internal audit activity.

(CIA Adapted)

Answers to Questions

1 b – Any attestation (coming to a conclusion) and risk assessment work will be done only by the external auditor. The internal auditor may do evaluating and reviewing, as long as it is the external auditor who makes the final conclusion or assessment.

2 b – One of the roles of the CAE is to coordinate the work of the internal and external auditors and to reduce the duplication of work.

3 a – This is one of the things that the CAE will do in an attempt to coordinate the internal and external audits and reduce the amount of work that is done twice.

4 d – By reviewing and testing the other departments' procedures, the internal auditor may reduce the necessary audit coverage of the function or process.

5 a – Oversight of external auditors is the responsibility of the board. The CAE should be responsible for coordinating work between internal and external auditors. However, it is possible that the board could request that the CAE provide input into the performance of the external auditor.

6 b – The overall professionalism of the internal auditor has improved, and the increased expense of external audits makes it imperative to eliminate duplication of effort and monitor more closely the hours worked by external auditors.

7 b – In any engagement, the deficiencies that are noted by the internal auditor should be reported to management. Choice (c) is incorrect because it may be appropriate for the audit to be conducted if management wants feedback about that at this point. It is not appropriate for the auditor to decide the appropriateness of the audit.

8 d – The four key responsibilities include (1) complies with society's legal and regulatory rules, (2) satisfies the generally accepted business norms, ethical precepts, and social expectations of society, (3) provides overall benefit to society and enhances the interests of the specific stakeholders in both the long term and short term, and (4) reports fully and truthfully to its owners, regulators, other stakeholders, and general public to ensure accountability for its decisions, actions, conduct, and performance.

9 b – The policies and procedures in place are dependent upon the size and complexity of the business. Choice (a) is incorrect because policies and procedures alone cannot ensure compliance with performance standards. They only help in the process. The same is the case with choice (c): the policies and procedures only assist in the consistency effort.

10 c – A small IAA can be managed more informally because the staff may be directed and controlled through close daily supervision. In a large IAA, it is generally necessary to have more formal and comprehensive policies and procedures in order for staff to be consistent in the compliance of the *Standards*.

11 c – The review of past risk evaluation reports is not a key objective of the risk management process. The internal auditor must determine that the organization's risk management processes address the five key objectives in order to formulate an opinion on the overall adequacy of the risk management processes.

12 c – This is a detailed test of the systems. However, the engagement in the question is evaluating the adequacy of the new policies and procedures in maintaining an appropriate risk profile. This test of some of the investments will not accomplish that objective.

13 c – Simply tracking interest rates over time will provide very little useful information in the assessment of the current investment strategy. Interest rates are affected by many factors outside of the control of management, perhaps most notably the economy and general economic environment.

14 d – Of the skills listed, this is the one that probably only the internal auditor has. Engineers, IT specialists, and cost accountants have more detailed knowledge of the items listed in choices (a), (b), and (c).

15 a – In order to broaden the staff auditor's knowledge, they need to be exposed to more areas. This is done through the rotation of auditors to different jobs.

16 b – In order to make certain that the internal auditors will be able to perform their duties, the CAE has a responsibility to provide counseling and training to the auditors.

17 d – Reporting the weekly activities of the individual internal auditors would not be included in the activity report submitted to the board and senior management. The board and senior management need summary reports that highlight significant issues, and so forth.

18 c – As part of the activity report, the CAE should include information about the status and completion of the engagements during the year.

19 d – Of the choices listed, the support that the audit committee can provide the IAA is of the greatest benefit. The other three choices are not things that the audit committee will or can do.

20 c – The first step is for the internal auditors to discuss the audit conclusions and recommendations with appropriate management. This allows the internal auditor the opportunity to verify the accuracy of the engagement communications. Then next step is to distribute to members of the organization that have the necessary power to ensure the results are given proper consideration, such as the audit committee.

21 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.

22 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.

23 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.

24 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.

25 a – The engagement work program is specific to the engagement and does not impact in determining the schedule of engagements to be performed.

26 b – It is important to recognize that the question is "Which of the following is least important?" Whether or not the external auditor audited the division last year is the least important of these factors listed. While the fact that it was recently audited is a good thing, it does not relieve the duty that the internal auditors have to monitor this potentially risky engagement on an ongoing basis.

27 c – While the board would like to think that they can determine what engagements should be performed, they cannot. The budget of the area is not a factor. Of the items listed, only the risk of financial loss or other detrimental results would be considered.

28 b – The addition of new staff is probably less important than the other factors listed. Matters to be considered in establishing the engagement should include: (a) length of time since last engagement; (b) request from senior management; (c) changing business environment; (d) changes in risk environment; (e) potential benefits; and (f) changes in skill level.

29 c – In all cases, work should be assigned to managers based on their skills and the risk analysis. Personal preferences and travel desires are not the way in which engagements should be assigned.

30 d – Personnel competence is a difficult thing to assess and measure. It is perfectly acceptable to use group consensus to do this. In fact, group consensus is probably better than an individual doing it because the group will hopefully eliminate any personal bias that one person has. Choice (a) is incorrect because risk assessment uses both quantitative and qualitative measurements.

31 a – Risk and the measurement of risk includes the assessment of the probability and the potential loss. Therefore, choices (b) and (c) are incorrect because they include only one of the two items. Choice (d) is incorrect because risk assessment cannot always be reduced to a numerical measure. Management judgment in an area may be a risk factor. The more that management has to make judgments, the more risk there is.

32 c – Facilitated team workshop is the process of gathering information from work teams that represent different levels in the business unit or function. The primary format of the workshop may be based on objectives, risks, controls, or processes.

33 c – The process-based format focuses on selected activities that are elements of a chain of processes. The general aim of this workshop is evaluate, update, validate, improve, and even streamline the whole process and its component activities.

34 d – Due diligence reviews are conducted primarily to justify a major transaction, such as an acquisition, joint venture, or divestiture.

35 a – To evaluate the merits of a lawsuit would take legal expertise. The internal auditor is supposed to have an appreciation of the fundamentals of law, not be a lawyer.

36 a – If the purchase price of the subsidiary depends on its profitability, then the internal auditors would want to pay special attention to the fixed asset capitalization procedures. It is possible that the former owners (now the managers) could capitalize some expenses, thereby increasing the firm's profitability and increasing the purchase price.

37 c – Comparing the quantities of scrap expected from the production process with the quantities sold would be the best way to ascertain that the sale of scrap is well controlled.

38 d – The method to use to determine whether improper services were billed would be to reconcile a sample of messenger invoices to pickup receipts. The internal auditor would be able to check whether any improper services were being carried out.

39 c – Since the contract is cost-plus, the internal auditor should have the right to review the costing system of the firm to ascertain whether the company is being properly charged.

