MO001/3/2015

Internal Auditing: Theory and Principles
AUI2601

Semesters 1 & 2

Department of Auditing

IMPORTANT INFORMATION:
This document contains important information about your module.

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CONTENTS

STUDY OVERVIEW

INTRODUCTION TO THIS MODULE: INTERNAL AUDIT: THEORY AND PRINCIPLES

This module is an introductory module to the world of internal auditing. It is a concise guide to the role and responsibilities of the internal auditor in the context of the global themes of corporate governance, risk management and control. Our aim is to show you what competent, responsible internal auditors encounter and do in their professional lives. You will discover how such auditors think and what they do. This module focuses on the context, role and work of the internal auditor as an introductory text. Once you have completed your degree, we would like you to be able to make a significant contribution, not only in your specific position, but also to the broader discourse of the internal auditing profession.

As a professional specialisation, internal auditing requires knowledge and understanding of theoretical foundations as well as professional proficiency in the practical aspects of internal auditing. The Institute of Internal Auditors (IIA) (2013) provides the following comprehensive definition of internal auditing:

> *Internal auditing is an independent, objective assurance and consulting activity designed to add value to and improve an organisation's operations. It helps an organisation to accomplish its objectives by bringing a systematic, disciplined approach, to evaluate and improve the effectiveness of risk management, control and governance processes.*

The following three main components emerge from this definition:
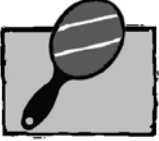
1. Internal auditing is an independent and objective assurance and consulting activity performed by a professional, namely, the internal auditor.

2. The objective of the internal audit activity is to assist the management of the organisation on all levels, to add value to the organisation's activities and to improve its operations.

3. This is accomplished by means of a systematic, disciplined approach to the evaluation and improvement of the organisation's operations.

Your study guide is divided into topics and learning units. As you work through them, you will encounter the following icons. We have included these to help you in your studies. Here is a list of all the icons that appear in the guide, and what each one represents.

Icon	Description
	Key concepts. The Key concepts icon draws your **attention** to certain keywords or concepts that you will come across in the topic or learning unit.
	Learning outcomes. The Learning outcomes indicate which aspects of the particular topic or learning units you have to master and demonstrate that you have mastered them.
	Study. The Study icon indicates which sections of the prescribed book or the study guide you need to study and internalise.
	Read. The Read icon will direct you to read certain sections of the prescribed book for background information.
	Activity. The Activity icon refers to activities that you must do in order to develop a deeper understanding of the learning material.

	Reflection. The Reflection icon requires you to reflect on the important issues or problems dealt within the learning unit.
	Feedback. The Feedback icon indicates that you will receive feedback on your answers to the self-assessment activities.
	Time-out. The Time-out icon indicates that you should take a rest because you have reached the end of a learning unit or topic.

STUDY SOURCES

There are no prescribed books for this module. Your study material consists of the study guide and the tutorial letters that you will receive during the semester.

PART A: NATURE OF INTERNAL AUDITING

TOPIC 1: THE DEFINITION OF INTERNAL AUDITING

INTRODUCTION AND PURPOSE OF THE TOPIC

In this topic we analyse the nature and objective of internal auditing and analyse and explain the elements of the definition of internal auditing.

LEARNING OUTCOMES

> **When you have worked through this topic, you should be able to**
>
> - explain the theoretical concepts underlying internal auditing in the context of the technical vocabulary associated with internal auditing by the use of context-specific examples.
> - analyse the definition of internal auditing.
> - describe the objective of an internal audit engagement in relation to the service provided to the organisation.
> - describe the main focus areas of an internal audit engagement in terms of the definition of internal auditing.
> - describe the misconceptions of internal auditing
> - describe the origin and development of internal auditing in terms of the development of the theoretical basis, professionalism and practice of internal auditing.

CONTENT OF THE TOPIC

This topic is made up of the following learning units:

Learning unit	Title
1.1	Describing internal auditing
1.2	Origin and development of internal auditing

LEARNING UNIT 1.1: DESCRIBING INTERNAL AUDITING

Let us begin this introductory module with some background information about where internal auditing fits in the organisation.

1.1.1 BACKGROUND

The controlling body (board of directors/control board) and the executive management (which we will refer to as management) are responsible for establishing the organisation and then ensuring that it operates successfully and efficiently. The board of directors is responsible mainly for the governance process (i.e. establishes and maintains corporate policies and provides information about its stewardship accountability), while executive management (management) is responsible for conducting the risk management and control processes. The audit committee is a subcommittee of the board overseeing the internal audit activity and external auditors.

The figure below shows you the position of the Board of Directors, the audit committee, executive management (CEO and CFO) and the internal audit activity in relation to one another in a company.
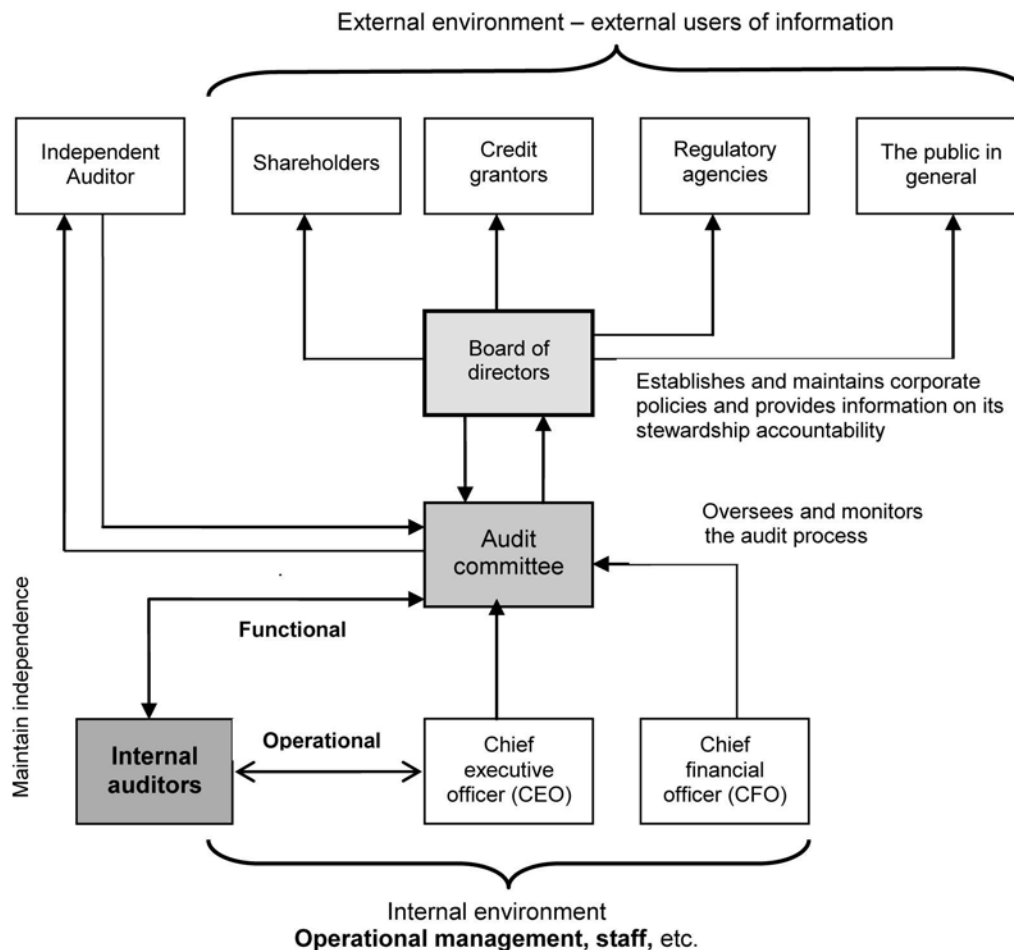
Figure 1.1: The accountability relationships within the organisation (Braiotta 2004:31)

Management must set goals; plan what has to be done and what means are to be used; organise to have the necessary means/people available at the right time; give guidance (direct), and exercise control to ensure that objectives are met; and keep records of all activities so that they are able to give account of their curatorship over the interests of the stakeholders. These aspects will be discussed in greater detail in learning unit 2.1.

Through the adoption of good governance principles, risk management and the system of internal control, management endeavours to ensure that assets and income are safeguarded and protected, operational efficiency is promoted, prescribed managerial policy is adhered to and carried out and that the operational and accounting justification is accurate, complete, useful and reliable. However, management cannot perform and monitor all aspects within an organisation on its own, because many organisations today are simply too large and complex. Management therefore delegates duties and

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responsibilities to subordinates for execution. This means that in most organisations, management is not involved in the day-to-day activities, and instead functions mainly as a policy-making body. As a result of the gap that has developed between the planning and the performance of tasks, management needs to be kept informed of the success or failure of the prescribed practices and to monitor performance relating to delegated tasks and responsibilities necessary to achieve operational objectives. The board and management need the internal audit activity to be their "eyes and ears" in evaluating and improving governance, risk management and control processes; in this respect, the internal audit activity adds value.

The overall objective of an internal audit is determined by the needs of the board and executive management, and the internal auditor must ensure that these needs are satisfied by the internal audit report, which he or she submits to the board and the audit committee.

The internal audit activity generally receives its assignments from management in the form of preplanned, approved areas to cover or special requests (ad hoc audits). In the course of their duties, internal auditors can identify areas that may benefit from exposure to audit, and offer suggestions to management about possible audit assignments. They therefore not only execute audit assignments, but may also indirectly initiate them, and then obtain approval from the board and the audit committee.

Like management, internal auditors must always be aware of the need for the audits they perform and ensure that their recommendations are cost effective.

The question is: How do you add value and improve operations?

Here the job of internal auditors really becomes interesting and exciting. Even though there are managers with knowledge and expertise at all levels in any organisation, the internal auditors must find something that can be improved upon. You have to make it better. The advantage internal auditors have is that everything can always be better; there is always room for improvement, and the internal auditor is in an ideal position to make this happen, since he or she is employed with the responsibility to look for ways to improve the whole organisation and to help the organisation accomplish its objectives.

In fulfilling this challenging role, internal auditors have to provide information to management about whether:

- only the plans approved by management have been executed or are being executed

- the anticipated results are being achieved

- the results can be improved

- management's plans proved to be effective

- where and how management can improve on their plans

Management uses the internal audit activity to gather and report this type of information relating to all aspects of the organisation. Internal auditing therefore has to do with all facets of management, and not only with accounting (i.e. the reliable and accurate keeping of accounts) and financial reporting.

To enable management to discharge their responsibilities effectively, the internal auditor should add value by consciously reviewing, analysing and appraising all possible operational variations in an undertaking, and give constructive criticism and advice and make cost-effective recommendations by reporting to management on the results of their examinations. Through improved processes and by adding value to all operations, internal auditors render a service, directly or indirectly, to all members of the organisation.

In answer to the question "What is internal auditing all about?" we could say that:

- The internal auditor is concerned with the examination of all forms of operational **and** financial activities at all levels of the entity. The internal auditor should always strive for efficiency in the achievement of results.
- Internal auditors are bound to an organisation, and regularly report to the board and management of the organisation.
- Internal auditors focus on accomplishing objectives, improving processes and adding value throughout the organisation.

1.1.2 DEFINITION OF INTERNAL AUDITING

In order to understand a field of knowledge, we need to describe (define) it clearly so that we have an accurate idea of the basic objective(s) and limiting factors relating to it, as well as the methodology followed to attain the objective(s). The definition of internal auditing is the cornerstone of internal auditing practice. It explains what internal auditing is and what internal auditors should do.

The definition of internal auditing, as approved by the International Institute of Internal Auditors in June 1999, reads as follows:

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

Please memorise this definition and make sure that you understand each one of its components. The following activities will help you do this.

Study and analyse the definition of internal auditing by underlining all the key concepts in the definition and thinking about what each one means.

In order to properly grasp any definition it is important to have a comprehensive understanding of all the components that make up the definition. The different components of the definition are described in the Collins English dictionary of 1998 as follows:

        INDEPENDENT   :   free from the control or influence of others

        OBJECTIVE   :   aim or purpose; when used as an adjective, not biased

ASSURANCE	:	promise or guarantee
ASSURE	:	convince; make certain
CONSULTANT	:	specialist who gives professional advice
OPERATION	:	method or procedure of working
SYSTEMATIC	:	methodical; according to a plan
DISCIPLINED	:	able to behave and work in a controlled way
APPROACH	:	begin to deal with; make a proposal or suggestion to
EVALUATE	:	find or judge the value of
IMPROVE	:	make or become better
EFFECTIVENESS	:	producing the desired result
RISK	:	hazard, for example, loss or damage
CONTROL	:	power to direct something; regulate
GOVERNANCE	:	government, control or authority; the action, manner or system of governing

Analysing the meaning of all the different concepts or words in the definition should enhance your understanding of the definition.

Explain the following aspects of the definition of internal auditing to illustrate the services provided by the internal audit activity:

- Independent and objective

- Assurance and Consulting

- Add Value and improve operations

- Risk Management Process

- Control Process

- Governance Process

Independent and objective

With regard to independence and objectivity, the IPPF Standard 1100 states that the internal audit activity must be independent and internal auditors must be objective in performing their work.

The IIA defines **independence** as follows:

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 organisational levels.

The IIA defines **objectivity** as follows:

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 organisational levels.

Assurance and Consulting

The IIA defines **assurance** services as follows:

An objective examination of evidence for the purpose of providing an independent assessment on governance, risk management, and control processes for the organisation.

Examples may include financial, performance, compliance, system security, and due diligence engagements.

EXAMPLES:

- The assessment that management's policies and procedures are adhered to.
- Examining whether control procedures are mitigating the risks identified.

The IIA defines **consulting** services as follows:

*Advisory and related client service activities, the nature and scope of which are agreed with the client, are intended to add value and improve an organisation's governance, risk management, and control processes **without** the internal auditor assuming management responsibility. Examples include counsel, advice, facilitation, and training.*

EXAMPLES:

- Conducting control self-assessment training.
- Providing advice to management on risk management, control and governance issues.
- Assisting in developing and drafting policies.

Add Value and Improve Operations

Adding value and, thereby, enabling continuous improvement, is a necessity for all organisations. Organisations exist to create value or benefit to their owners, other stakeholders, customers, and clients, and must constantly strive to do things better. This concept provides purpose for their existence.

The IIA defines **add value** as follows:

The internal audit activity adds value to the organisation (and its stakeholders) when it provides objective and relevant assurance, and contributes to the effectiveness and efficiency of governance, risk management, and control processes.

Value is provided through the development of products and services and the use of resources to promote those products and services. In the process of gathering data to understand and assess risk and control, internal auditors develop significant insight into operations and opportunities for improvement that can be extremely beneficial to their organisation. This valuable information can be in the form of consultation, advice, written communications, or

through other products all of which should be properly communicated to the appropriate management or operating personnel to assist the organisation as a whole. By stating that internal auditing "adds value and improves", the definition underscores the profession's commitment to serving the needs of the organisation and helping the organisation to **accomplish its objectives**.

Risk Management Process

The internal audit activity should assist the organisation in managing risk. It should do this by identifying and evaluating the organisation's exposure to risk, assessing risk during the course of engagements, and improving the risk management process.

The IIA defines **risk management** as follows:

A process to identify, assess, manage, and control potential events or situations to provide reasonable assurance regarding the achievement of the organisation's objectives.

Thus, a risk is any event or situation that can hamper the achievement of an objective (organisational objective).

Control Process

The internal audit activity should evaluate the organisation's control process to determine its effectiveness and efficiency.

The IIA defines **control processes** as follows:

The policies, procedures (both manual and automated), and activities that are part of a control framework, designed and operated to ensure that risks are contained within the level that an organisation is willing to accept.

Thus controls are implemented to minimise or sometimes mitigate potential risks.

Governance Process

The internal audit activity should assist the organisation in achieving its goals by evaluating and improving the process through which (1) goals and values are established and communicated,(2) the accomplishment of goals is monitored (3) accountability is ensured, and (4) values are preserved.

The IIA defines governance as follows:

The combination of processes and structures implemented by the board to inform, direct, manage, and monitor the activities of the organisation towards the achievement of its objectives.

1.1.3 OBJECTIVES OF INTERNAL AUDIT

The main objective of internal auditing is determined by the needs of the board of directors and management of an organisation so as to assist them in improving the governance, risk management and control processes as well as the effective discharge of its responsibilities. The internal auditor must ensure that these needs are addressed in the internal audit report that should be issued after each audit engagement.

This can be achieved by means of the following:

- an interpretation of factual circumstances and events in the organisation that have been exposed by the internal auditor's examination (reactive evaluation – assurance service)
- constructive and cost-effective suggestions to identify risks and to eliminate problems and/or to improve the efficiency and effectiveness of the organisation's governance, risk management and control processes (proactive evaluation – consulting service)

There is a misperception in the business world that the main duty of an internal auditor is to uncover fraud and error. If internal auditors are to win full professional status and acceptance, they will have to correct this misperception. We will say more about the internal auditor's role in fraud prevention and detection in learning unit 5.2.

The discovery of fraud and errors is, however, an important factor that an internal auditor needs to take into consideration in the performance of his or her duties.

1.1.4 MAIN FOCUS AREAS OF INTERNAL AUDITING

The activities of any organisation comprise of two main components, which also form the two main focus areas of the internal audit activity. They are:

(1)   managing the organisation, which includes goals, policies, decisions, control and governance.

(2)   performance, recording and administration of the activities

The focus areas of internal auditing comprises of assurance and consulting services.

Assurance services

The first focus area of internal auditing is **assurance services**. These services comprises of the examination and appraisal of the record-keeping and control systems relating to the administrative, operational and financial aspects of an undertaking. Assurance engagements are conducted for the purpose of providing independent assessments. Internal audit is generally employed for these services.

With regard to providing assurance services, the role and activities of the internal auditor could be summarised as follows:

1.   reinforcement (supportive function) of all systems and controls (operational, administrative and financial) by evaluating their adequacy and application
2.   reviewing the reliability of records (administrative, operational and financial)
3.   assisting directly with the discovery of fraud and error (refer to the internal auditor's role in fraud)
4.   assisting indirectly with the prevention of fraud and error by recommending and ensuring the proper function of controls.
5.   determining whether management policies are being complied with in all respects
6.   determining whether all applicable statutory requirements are being complied with
7.   determining whether procedures relating to reporting are being complied with

Consulting services

The second focus area of internal auditing is **consulting services**. Consulting services are advisory in nature and often are conducted at the request of management. Consulting services are tailored to resolve specific issues that management has identified. These services can be advisory, training or facilitative. They could comprise the examination and appraisal of, for example, the managerial (operational) aspects, due diligence and project assessment of an undertaking.

The role and activities of the internal auditor in providing consulting services for internal auditing may be summarised as follows:

1. independence from the normal policy-making function (i.e. the executive management function) by only identifying and recommending areas of improvement or change
2. examining and evaluating the goals, policy, decisions, standards, procedures and controls of management
3. conducting special assignments requested by management where internal audit can add value through their knowledge and skills, yet still remain independent and act in an advisory capacity based on the results of such assignments
4. communicating in an authoritative manner with management by means of reporting to improve and add value

Answer the multiple-choice question below.

Within the context of internal auditing, **assurance services** are best defined as:

A. Objective examinations of evidence for the purpose of providing independent assessments.
B. Advisory services intended to add value and improve an organisation's operations.
C. Professional activities that measure and communicate financial and business data.
D. Objective evaluation of compliance with policies, plans, procedures, laws and regulations.

A is the best answer. Assurance services are defined in the glossary to the Standards as "*an objective examination of evidence for the purpose of providing an independent assessment on governance, risk management, or control processes for the organisation. Examples may include financial, performance, compliance, system security, and due diligence engagements.*"

1.1.5 MISCONCEPTIONS OF INTERNAL AUDITING

The main misconception about internal auditing is that it is the same as external auditing (external auditing is carried out by chartered accountants, or CAs).

To clear up this misconception, let's start by examining the **objectives** of internal and external audit:

The **external auditor** seeks to test the underlying transactions that form the basis of the financial statements. From these tests, he or she forms an opinion as to whether or not these statements present a true and fair view.

The **internal auditor**, on the other hand, seeks to advise management on whether its major operations have sound systems of risk management and internal controls.

The key differences are summarised in the table below:

Table 1.1 The key differences between an internal audit and an external audit (Adapted from Spencer Picket (2010: pages 91-94))

Factor	Internal audit	External audit
Organisational structure	Internal audit can be an external contractor **or** an in-house function.	External audit is an external contractor, never an employee of the company.
Objectives	Internal audit forms an opinion on the adequacy and effectiveness of systems of risk management and internal	External audit seeks to provide an opinion on whether the accounts/financial

	control, many of which fall outside the main accounting systems.	statements present a true and fair view of the organisation.
Audit coverage	Internal audit covers all the organisation's operations.	External audit works primarily with those financial systems that have a bearing on the final accounts.
Audit timeframe	Internal audit performs audits throughout the year.	External audit tends to be a year-end process, even though some testing may be carried out during the year.
Staff structure	Staff consists of Chief Audit Executive (CAE), managers, senior and junior internal auditors	Staff consists of partners, managers, seniors and trainees.
Staff	Competent persons trained in internal auditing.	Qualified CAs and partly qualified accountants.
Methodology	Risk-based audits – assurance and consulting services.	Vouching and verification and some use of risk-based systems approach.
Certification	Certified Internal Auditor (CIA)	Chartered Accountant (CA)
Membership affiliation	Institute of Internal Auditors (IIA)	South African Institute of Chartered Accountants (SAICA)
Legislation	Legally required in the public sector, encouraged in private sector.	Legally required for all registered companies and the public sector (small companies may have exemptions).

Answer the questions below.

1. Identify and discuss the main and ancillary objectives of an internal audit.
2. Identify and discuss the **two** main focus areas of an internal audit.

Feedback on review questions

Question 1

The **main** objective of internal auditing is determined by the needs of the management of an organisation in order to assist them in the improvement of risk management, control and governance processes as well as the effective discharge of their responsibilities. The internal auditor must ensure that these needs are satisfied by the internal audit report addressed to management.

The uncovering of errors and fraud is an **ancillary** objective.

Question 2

The first target area comprises the examination and appraisal of the managerial and operational aspects of an organisation (consulting services).

The second target area comprises the examination and appraisal of the record-keeping and control systems relating to the administrative and financial aspects of an organisation (assurance services).

LEARNING UNIT 1.2: ORIGIN AND DEVELOPMENT OF INTERNAL AUDITING

1.2.1 DEVELOPMENT OF INTERNAL AUDIT PRACTICE

If you want to become part of a profession and want to be a good ambassador for your profession, it is important for you to know where the roots of such a profession lie. Where did it all start and why "Internal Auditing"?

The concept of Auditing can be traced back to biblical times. The ancient pharaohs appointed governors to guard and monitor the building of the pyramids, and the Greeks and Romans assigned officers to monitor and report on the progress of their armed forces in the countries they conquered.

In the Middle Ages, the King's representatives kept records of the types and quantities of items on ships to ensure that the correct amount of tax was paid on each load and that it had been accurately accounted for. According to research by Flesher, Greek literature contains information regarding internal investigations performed on Egyptian Farms owned by the Greek ruler Ptolemy Philadelphius II, approximately 500 years BCE. During these "internal audits" the focus was on improving management's control over operations – similar to the focus of internal auditing today (Marais 2003:2–3).

Sawyer sums up the development of internal auditing as follows:

Internal auditing evolved from an essentially accounting-oriented craft to a management-oriented profession.

Although this quotation is so brief, it holds the key to understanding the nature of internal auditing. Throughout your study of this subject, remember that although internal auditing developed from accounting, it has become a management-oriented profession, the primary aim of which is to help management achieve their objectives and add value through improving management processes.

This is why the BCom (Internal Auditing) degree includes accountancy, auditing and strategic management modules in the final-year curriculum.

1.2.1.1 Development in the United States of America

The following development phases in internal auditing in the United States of America are distinguished by MJ Barrett in his article in the Internal Auditor of June 1980. The evolution of internal auditing in the USA is very representative of international developments.

- **End of the nineteenth century:** The mission of internal auditing, where it existed was internal security: detecting theft of cash, valuable rights and goods or services by employees and others. The company accountant and the external auditor were responsible for the accuracy of the accounting records and financial statements.

- **The period 1900–1920:** The point of view propagated by Frederick W Taylor, namely, that productivity increases when planning and physical operations are separated, was accepted. Management's efficiency and accounting controls were improved by segregating the functions of authorising, executing, recording and accountability. As a result of this development, auditors of large concerns were able to justify higher costs for the implementation and maintenance of financial controls. The separation of planning and physical operations also contributed to the improvement of accounting controls.

- **The period 1920–1929:** In addition to reporting on financial controls, the duties of the internal auditor were expanded to include the discovery of fraud and error. Audits in respect of the accuracy of records of account, limited branch audits, and the reconciliation of branch accounts with their financial statements, stocks and cash, were undertaken during this period. This resulted in the closer involvement of the internal auditor with the financial reporting of an undertaking. In as much as it directly concerned the accounting function, the internal auditor's contribution toward management efficiency increased during this period.

- **The period 1929–1940:** The complexity of accounting accountability increased as a result of the growth of organisations and the increasing demands of management, shareholders and authorities for the timely availability of information. Greater emphasis was placed on the substantiation of the authorisation and accountability of each transaction to prevent the occurrence of fictitious transactions. This was the origin of internal accounting control. Over and above the discovery of fraud and error, the internal auditor had to ensure that every transaction was properly authorised and

correctly documented and accounted for, which meant a further expansion of responsibilities.

- **The post-1940 period:** Higher standards of business responsibility were set for company management by the public and shareholders. The involvement of company directors in management affairs increased inter alia through audit committees. Businesses grew and expanded further. All these factors contributed to an increased demand and need for the services of internal auditors.

The establishment of the first institute of internal auditors in the USA in 1941 brought about an important change in the internal auditing task. One of the considerations that motivated a small group of internal auditors to establish the institute was the need to expand the task of internal auditors to include assisting (supporting) the management of organisations with management functions while maintaining their independence by not taking over management's responsibility.

The status of internal auditors increased accordingly. The membership of the Institute of Internal Auditors in the United States of America grew from 24 members in 1941 to the current figure of more than 70 000 in North America and 180 000 globally. During this period a comprehensive range of works on this subject was published and professional standards were introduced in the United States of America. The first course in internal auditing was offered during 1944 by the University of Richmond in collaboration with the United States Office of Education.

The adoption of the Foreign Corrupt Practices Act of 1977, and the role of the Securities and Exchange Commission (SEC) and the Inspector General Act had the greatest impact on the demand for and acceptance of internal auditors in USA.

Due to Enron and other scandals, members of the US Congress felt the need that the existing process of establishing auditing standards was not working. The result was Sarbanes-Oxley Act (SOA) passed in 2002. With SOA, the importance of internal audit as a key component of corporate governance had been enforced.

The original goal of assisting management was only really achieved during the eighties. Currently, informed and responsible internal auditors regard this task as their most important function. The auditing of financial transactions and records is naturally still carried out because it is an essential function. Conducting an auditing practice in which assistance to management is the goal is very much in line with the current definition of internal auditing. All the internal auditing publications advocate this approach and training programmes make provision for teaching this approach.

Since 1990 more body and structure has been given to the Internal Auditing standards and guidance and the internalisation of the IIA has received greater emphasis.

During the nineties, the research foundation of the IIA in the USA carried out extensive research into the function and responsibilities of internal auditors as well as the knowledge they need to acquire. This research led to the most comprehensive report on the current nature and function of internal auditing, which was published in 1999 under the title Competency framework for internal auditors (CFIA), which consists of six volumes (984 pages). These research results brought about a drastic change of direction in internal auditing, since the emphasis shifted from reactive to proactive internal auditing.

During the nineties, two other important research reports were published, which had an important influence on the practice of internal auditing.

The first of these two reports, which are referred to above, was published in the USA in 1992 by the Committee of Sponsoring Organisations of the Treadway Commission (COSO), first in four volumes and then, in 1994, in two volumes. The second report, which took the COSO report further, was published in 1995 by the Criteria of Control Boards of the Canadian Institute of Chartered Accountants (the CoCo report). The content of these reports shifted the emphasis away from the traditional internal control over the activities of an organisation to the full spectrum of components of control of an organisation, of which internal control over the activities of the organisation is only one.

In both these reports, and in the CFIA, major emphasis is placed on the identification and evaluation of risk in an organisation. The first volume of the COSO report consists mainly of the explanation of the five components of the control framework, namely, control environment, risk assessment, control activities, information and communication and monitoring, and the second volume, in three parts, describes the evaluation tool.

- The first part gives the focal points of each of the five components of control without supplying any examples of relevant descriptions of the focal points.
- The second part consists of a comprehensive reference manual discussing the following in respect of all activities of a generic organisation:
  - objectives

- the main type of audit that is appropriate, namely, an operational, financial or compliance audit
- relevant risks
- focal points for action or control activities
- The third part is the same as the first, but includes examples of descriptions of or comments on each focal point.

These developments led researchers David McNamee and Georges Selim to the conclusion that the broad development of internal auditing practice has now moved into the third paradigm phase, namely the risk phase.

This new paradigm rests on three main pillars:

- organisational objectives
- risks associated with the achievement of these objectives
- controls for managing these risks

The publication of the COSO and CoCo reports and the Competency Framework for Internal Auditors (CFIA) laid the foundation for the recent important new approach in internal auditing practice, as well as for the new definition of internal auditing and the new International Professional Practice Framework (IPPF).

Another important internal auditing technique emerged during this period and has already gained general acceptance. This technique, control self-assessment, is already widely accepted and is supported by the IIA through their certification of the control self-assessment (CSA) qualification, which is referred to as CCSA (Certification in Control Self-Assessment) and is already being applied at various large organisations throughout the world.

The main reason why those who use this technique hold it in such high esteem is that it makes it possible for both the management of the organisation and the internal audit activity to exercise better general control over the activities of an organisation. We will say more about CSA in learning unit 6.1.

All the above developments jointly form the basis for the current proactive approach to internal auditing practice. The most recent developments in risk-related issues in which internal auditors are adding value to their companies are found in the Enterprise Risk Management (ERM) – COSO report. As a natural consequence of their focus on overall corporate risk assessment,

control self-assessment, and risk-based auditing, internal auditors are promoting their role in business risk management models. You will learn more about ERM and risk-based internal auditing and risk management in learning unit 6.1.

You can access the executive summary of this report directly at: www.erm.coso.org.

A serious financial fraud crisis in the USA led to the promulgation of the Sarbanes-Oxley Act in July 2002, which dramatically curtailed many of the non-audit functions of external auditors, further expanding and strengthening the position of internal auditors.

This act requires the chief executive officer and chief financial officer to certify that their internal controls operate to safeguard material financial business processes. A requirement that supports the need for and use of internal audit is the Common Body of Knowledge (CBOK).

In an effort to understand, shape, and advance the profession, the Institute of Internal Auditors Research Foundation (IIARF) has carried out the most comprehensive global study ever conducted on the internal audit profession. This study, CBOK, has produced a rich database of information on how the profession is being practised worldwide. If repeated periodically, CBOK will enable the IIA and its institutes to track the profession's progress in achieving an ideal state all around the globe.

The latest CBOK study was conducted in the form of carefully-engineered surveys to Chief Audit Executives (CAEs), internal audit practitioners at all levels of experience, and IIA chapter and institute leaders. These surveys determined the following:

- Compliance with and the adequacy of the International Standards for the Professional Practice of Internal Auditing as well as

- the current status of the internal audit activity within organisations
- the activities and types of audits that are being performed
- tools and techniques used by internal auditors
- skills and knowledge possessed by internal auditors

1.2.1.2   Development in South Africa

The development of internal auditing practice in South Africa (SA) has followed a similar process to that in the USA.

1.2.2 DEVELOPMENT OF INTERNAL AUDITING INTO A PROFESSION

Many occupations strive to be recognised as a profession. While medical doctors, lawyers, and practitioners in similar fields are termed "professionals", the term "professional" is also applied to people who practise other careers who receive remuneration for their specific and unique contributions – so, for example, it is applied to athletes, chefs, and building inspectors. However, in evaluating a learned discipline for professionalism, as distinguished from a trade or craft, we must apply criteria of a different kind.

On the basis of these criteria, a professional person can be described as a person who, within his or her specific profession, under self-determined standards, for his or her own account, but on a basis of service, makes his or her specialised knowledge and expertise available to his or her client, in a manner that will be both acceptable and indispensable to his or her client and to society as a whole.

From the criteria that govern the granting of professional status, it is evident that professional societies with similarly qualified members are an important element in any profession's claim to professional status. These societies control the standards with which members must comply in order to be admitted to the profession in question; they set standards of conduct for members, and also impose disciplinary measures in the event of unethical behaviour.

The mere existence of a professional body for a specific profession is not in itself sufficient to confer professional status. All the above-mentioned requirements must be met.

If we critically review the criteria for professional status, we recognise that in addition to the main requirement, namely, association in professional societies, there is an additional requirement, namely, acceptance and acknowledgement by the public. A group of practitioners cannot unilaterally declare themselves to be a profession. The persons to whom they render a service must ultimately acknowledge and accept the group as professional practitioners.

Professionalism and Internal Auditors

In the Middle Ages, law, medicine, university teaching, and religion were considered the learned professions. In the early 1900s, dentistry and architecture were added. Certified public accounting and engineering have since also entered the professional field.

Internal auditors have some catching up to do. Yet they have made remarkable progress in a relatively short time. Many of the criteria of professionalism that we discussed above have been or are being met.

In brief, these criteria or elements of a profession are as follows:

1. A **specialised service** must be rendered to society.
2. Specialised subject knowledge, which should be acquired through formal **training programmes**.
3. Members of the profession must observe a prescribed **code of ethic**s when dealing with clients, colleagues and the public in the practice of their profession.
4. **Common Body of Knowledge** to be associated with the discipline and profession.
5. Membership of a **professional association**, and the acknowledgement and recognition of the professional status of the profession and attendance of meetings.
6. **Publication** of journals aimed at upgrading practice.
7. **Examinations** to test entrants' knowledge.
8. **Statutory recognition** and **licensure** by the state or certification by a board.

1.   Service to society

A profession should provide a service to society as opposed to individual clients. This is done by promoting the efficient and effective use of resources. Moreover, their code of ethics requires members of the IIA to avoid being party to any illegal or improper activity.

If we take into account the nature and function of internal auditing and the specialised knowledge the internal auditor must possess, there is no doubt that he or she does render a specialised service, although it is not rendered directly to society as such. An indirect service is rendered to society in that

- organisations in the private sector are managed more efficiently and show greater profits
- public sector institutions are more efficiently managed and the taxpayer's money is utilised properly.

This indirect service is probably not yet seen in the correct perspective and properly appreciated by the public at large and is, therefore, not generally recognised as a professional service. Another important obstacle to recognition by the general public is the fact that the internal auditor does not render a service for his or her own account but is paid by the organisation for which he or she works. These circumstances raise questions regarding the professional independence of the internal auditor.

The profession does not receive direct statutory recognition in South Africa as yet, but the service of internal auditing is recognised through the Public Finance Management Act 1 of 1999, which provides, among other things, that the institutions to which the Act applies should each have and maintain a system of internal audit. The Act does not specify who should perform this service, that is to say, what qualifications the person conducting the internal audit should possess. This legislation gives direct statutory recognition to the nature of the service rendered by the internal auditor.

Another source of recognition for internal audit profession is the King III report (further discussed in Learning unit 1.2.2.2). In King III report, the importance of internal audit is highlighted. In addition to responsibilities of internal audit being stated, King III also recommends the internal audit approach (risk-based) and its status in the company. King III reinforces the need for internal audit by stating that the board should ensure there is an effective internal audit (King III, Principle 7.1) and the audit committee who should oversee the internal audit function (King III, Principle 7.4).

These circumstances are indicative of general recognition in South Africa of the specialised professional service rendered by internal auditors.

2.   Specialised subject knowledge and formal training programmes

This is not a requirement in all countries. Many internal audit departments accept people with varying degrees of training or learning. These people cannot say that they are professionals. However, others, who have demonstrated training, passed tests and earned certification, can properly regard themselves as professionals and reach practitioner status.

The International Institute of Internal Auditors in the USA has, through extensive and scientifically conducted research, established a common body of knowledge that an internal auditor should possess. This information was accepted by the International Institute, and constitutes the formal body of knowledge that serves as the basis for the formal professional examination for the qualification of certified internal auditors (CIAs).

In addition to this required theoretical knowledge, evidence of a certain minimum period of relevant practical experience must also be submitted. To retain this qualification, the holder must also submit evidence of continuous training (known as continuous professional development, or CPD).

The CIA qualification is internationally recognised, and is highly regarded by related professions such as the accounting and auditing professions in both the private and public sectors. Internal auditors in South Africa also obtain this international qualification; there is no comparable South African internal auditing qualification. Because it is held in such high regard, increasing numbers of people in South Africa are obtaining this qualification.

The internal auditing profession, therefore, complies fully with this requirement for professional recognition.

3.   Code of Ethics

Members of the IIA must subscribe to the code of ethics, and follow the Standards. The code of ethics provides a moral framework within which individuals may practise, in representing the entire profession.

4.   Common Body of Knowledge

There is a CBOK for the discipline. This represents the minimum level of knowledge that is studied and understood, and must be mastered. The precise content may change as the profession changes and adapts.

5.   Professional association

A professional body represents the interests of its members and this is prescribed by many of the other requirements discussed. The Institute of Internal Auditors is unquestionably a

professional association or body. Yet in many countries, including the United States, the Institute accepts as members those who may be practising internal auditing but who have not been certified. In other countries, such as Ireland and England, passing certain tests is a requirement for full membership. The Institute may, therefore, have to consider a separate branch, restricted to CIAs, who are board certified and who must follow a continuing education programme requiring 80 hours of education over a 2-year period.

Internal auditors are well organised at both the national level (through the IIA – South Africa) and at the international level (IIA, Inc – USA). Membership of these bodies does not, however, give the holders the exclusive right to act as internal auditors. As a result, despite the professional certification programme, there is no standard of professional knowledge and skill with which internal auditors are forced to comply before being allowed to practise. Membership of the international and local institutes is not exclusively dependent on the qualifications obtained under the professional certification programme.

Minimum professional standards and ethical codes have been compiled and formally adopted by the international institute. The local institute is affiliated to the international institute and members should, therefore, adhere to all professional standards as adopted by the IIA Inc.

Because membership of these bodies is not compulsory for people who wish to practise the profession, the standards and ethical rules cannot be enforced for non- members.

Through its affiliation with the International Institute of Internal Auditors, the South African institute is able to keep its members up to date on the latest international developments in the field of internal auditing. Information is supplied through the medium of publications, educational material, research articles, an official journal and international continuing education programmes.

6.   Publication

In terms of publications, the IIA publishes a technical journal, *Internal Auditor*, as well as technical updates and books, research studies, monographs, audio-visual presentations, and other means of instruction. Contributions to these publications are made not only by practitioners, but also by respected academics, and in the form of research studies that examine subjects of interest to members.

7.   Examinations

The institute began its certification programme in 1974. Previously, it called for candidates to pass four rigorous examinations, covering a wide range of subjects. Successful candidates received the designation of CIA after also meeting practical experience requirements. As of the

beginning of 2014, the IIA South Africa introduced a compulsory learning pathway for those who want to be designated a CIA. Internal auditors have to first serve articles of Internal Audit Technician (IAT) and Professional Internal Auditor (PIA) before sitting for the international CIA exam. This also provides a professional designation (IAT and PIA) for those who do not want to become full-fledged CIAs. Another change is that the international CIA exam syllabus is now divided into three parts. As a foundation for the examination, the institute established and updates a common body of knowledge for those preparing to write the examination. The process of formulating the examination syllabus is useful, as it forces one to define the scope of work and level of competence required.

8.   Statutory recognition and licences.

The practice of internal auditing is not limited to licensees. Anyone can be hired as an internal auditor; all the person has to do is convince his or her employer that he or she has the necessary internal auditing capability. Lack of certification is no bar. Anyone working as an internal auditor can sign an internal audit report and render an internal audit opinion. However, there are signs that this situation is changing. Some internal auditing organisations now insist that all members be certified, or be working toward certification.

As you can see, many attributes of a profession apply to internal auditing: a common body of knowledge, a certification programme, a continuing professional development programme, a Code of Ethics, a set of International Standards, a professional journal, and an increasing flow of literature.

Today, after more than half a century, we can confidently say that internal auditing has made great progress toward professionalism. The most important development in this regard is that the specialised service of internal auditing, including the expertise and skill it requires, is in demand in both the private and public sectors, with the result that the profession has become firmly established and is widely acclaimed.

1.2.2.1   Development in the USA

Although internal auditing, like external auditing, has been practised in one form or another for a long time in both the private and public sectors, the first international formal move in the direction of professionalism took place in the USA in 1941 with the establishment of the Institute of Internal Auditors (IIA). The overall aim of this body was to formalise and generalise the services rendered by internal auditors so that this service could be awarded recognition as a profession.

Internal auditors in the USA took the lead, and it was in that country that the most decisive step towards professionalism took place, although the goal was in fact international support for the field. This goal has largely been achieved, because the institute's head office in Orlando, Florida in the USA seems to be regarded as the international head office. The stated policy of the institute is internationalism in all respects. People from other countries regularly serve on the institute's executive committee. From time to time the IIA has had presidents from countries outside the USA. The motto of the IIA, "Progress through sharing," embraces everything the institute represents.

This internationalisation of the internal auditing profession is well established today. National institutes of internal auditors now exist in almost all the most important countries of the world, and most of these institutes are formally affiliated to the international head office in Orlando.

This internationalisation of the internal auditing profession is well established today. National institutes of internal auditors now exist in virtually in all the most important countries of the world – in all the continents – and most of these institutes are all formally affiliated to the international head office in Orlando.

For many years the institute has organised an annual international conference, which has been attended by delegates from all parts of the world. This conference was hosted in South Africa for the first time in 2009.

The most important aim of all these activities is to promote the professional status of internal auditing.

It is clear from the above description that professional association is already a well- established process among internal auditors. This aspect probably makes the most important contribution to professional prestige, since professional concerns of all kinds are dealt with at the association level. These concerns include the following:

a. Membership

The establishment of the IIA led to one of the most important requirements for professionalism, namely the organisation of the members of the profession into a professional body, being met. Membership of the association is restricted to persons with the required knowledge and skills, and members are expected to conform to the association's professional code of ethics and international standards.

Members who comply with the educational and practical criteria can adopt the designation Certified Internal Auditor (CIA).

An important requirement for full professionalism is that the professional body should have the power to take disciplinary action against members who contravene the code of ethics and the international standards. In the case of internal auditing, the IIA can discipline its own members, but it cannot discipline people working as internal auditors who are not members of the IIA.

The IIA's mission is to provide dynamic leadership for the global profession of internal auditing. This includes,

- advocating and promoting the value that internal audit professionals add to their organisation
- providing comprehensive professional education and development opportunities, standards and other professional practice guidance, and certification programmes
- researching, disseminating and promoting knowledge about internal auditing and its rightful role in control, risk management and governance among practitioners and stakeholders
- educating practitioners and other relevant audiences on best practices in internal auditing
- bringing together internal auditors from all countries to share information and experiences

b. The establishment of a Code of Ethics and International Standards

After the IIA was founded, a number of years passed before the first Statement of Responsibilities (1947), the first Code of Ethics (1968) and the first Standards (1978) were adopted. These publications were subsequently amended and expanded into a series of Statements on Internal Auditing Standards (SIAS), which were integrated with the professional standards and published as the International Standards for the Professional Practice of Internal Auditing. These standards were regarded as the cornerstone of professional internal auditing.

A professional practices framework (PPF) was approved by the board of directors of the International Institute of Internal Auditors in June 1999. This framework provides a structural blueprint of how a body of knowledge and practical guidance can be integrated. A number of modifications and additions to the standards were made subsequently, and became effective in January 2004.

The new International Professional Practices Framework (IPPF) was introduced in January 2009. Changes made to the 2002 standards were:

- interpretations to certain standards

- new standards and amended wording of the 2002 standards

- new terms and modifications to existing terms within the glossary.

Compliance with the definition of internal auditing, the International Standards and the Code of Ethics in the framework is mandatory for all the members of the IIA. The Position Papers, Practice Advisories and Practice Guides are strongly recommended. The public sector in South Africa is required by the Public Finance and Management Act (PFMA) and the Municipal Finance Management Act (MFMA) to comply with the standards described in this framework. The King III Report also recommends compliance.

c. Education and training

In 1972, thirty years after its founding, the IIA issued the first formal requirements for a common body of knowledge for internal auditors. This was an important milestone along the road to professionalism, because this step identified and made known the important specialised knowledge internal auditors should have in order to render their specialised service. This publication set out the important skills the internal auditor needs.

The second publication of this nature appeared in 1985. The stated aim of the researchers investigating this body of knowledge was to ascertain what professional knowledge practising internal auditors require. This study included more than mere knowledge; it identified three elements, namely, knowledge of the relevant specialities, skill in carrying out the relevant internal auditing tasks and the experience (measured in years) required to function as a professionally qualified and skilled internal auditor.

A third research report on the professional knowledge and training required was published in 1992. The aim of this updated version of the required body of knowledge was to include the demands made on the internal auditor by developments such as technology. This study also investigated the question of what knowledge is required to pass the professional (CIA) examination of the IIA.

A formal professional certification programme, the certified internal auditor (CIA) qualification, was introduced, and the first examinations were taken in 1974. Candidates are required to pass this examination and acquire the required practical experience before they are awarded this qualification.

In the USA the profession does not yet enjoy legal protection and recognition, but there are various important laws which provide an indirect stimulus for the internal auditing profession in that they make internal audits compulsory for certain bodies under certain circumstances. The legislation does not specify who should carry out the internal audits. The provisions of the legislation do, however, recognise internal auditing as a specialised service, which is an extremely important contribution toward professionalism. The report of the Treadway Commission, which investigated fraud in financial reporting, was published in 1987 and contained important recommendations with regard to internal control and internal auditing.

This report supported the general recognition of internal auditing as a specialised service that makes an important contribution to general control in organisations.

The Sarbanes-Oxley Act of 2002 and the resulting amendment to the Security and Exchange (SEC) regulations have put the internal audit activity in the spotlight as one of the agents that ensure corporate effectiveness. This piece of American legislation raised the vital role of internal auditing in corporate governance to its greatest prominence ever.

The institute publishes a bimonthly journal, the *Internal Auditor*, which is internationally distributed and is highly regarded by members. This journal makes an important contribution to the standing of the profession.

1.2.2.2   Development in South Africa

The initial development of internal auditing in South Africa followed long after developments in the USA. The Institute of Internal Auditors of South Africa was established on 11 November 1964 as a national institute, affiliated to the international institute in the USA.

The professional standards and other formal publications adopted by the international institute and accepted by members were formally adopted in South Africa by the local institute and made applicable to its members. However, as in the rest of the world, non-members cannot be forced to accept these standards. Membership is confined to people who have a formal academic or professional qualification or have had a minimum number of years' experience of internal auditing or other relevant practical experience. Internal auditors in South Africa who want to obtain a professional qualification write the examination for CIA certification.

The most important activity of the local institute is to present a series of seminars annually on important topics for the purposes of training and the exchange of knowledge and also as a form of CPD.

Over the past few decades the local institute has published a professional journal (*IA Adviser*) and a newsletter, both of which have helped to develop the profession in this country and make it more widely known. Several international conferences have also been held, and over the past few years a national conference has been held annually.

Two important events in South Africa made a large contribution to the establishment of internal auditing as a specialised service and to the recognition accorded to the profession. The first was the publication of the Reporting by Public Entities Act 93 of 1992. This Act has been replaced by the Public Finance Management Act 1 of 1999, which applies to departments and public entities listed in Schedule 2 or 3, constitutional institutions and Parliament and the provincial legislatures, subject to subsection (2). According to this Act, the above institutions should all maintain a system of internal audit. The requirements of this Act include the stipulation that any organisation which is classified as a public entity must cause an internal audit to be conducted into the economical and efficient management of its resources and the effective performance of its functions. The Act does not specify who should carry out this internal audit.

The second event was the report of the King Committee on Corporate Governance in South Africa, which was published in November 1994 by the Institute of Directors. This report makes extensive recommendations in respect of the internal auditing of the operations of large South African institutions. The report makes no specific recommendation on who should be appointed to undertake the internal audit. The recommendations are not generally enforceable, except for the fact that the rules of the JSE Securities Exchange have been modified to require a listed company to carry out an internal audit of its operations in line with the recommendations by the King Report.

The second and revised King II was published in 2002, which recommends that every board of directors and every individual director should be held responsible for good corporate governance, namely, establishing and maintaining good corporate governance. This review was necessitated mainly by the numerous changes which have taken place in the social and political spheres since 1994. The King II report also explains the responsibility of other parties. For example, management (other than the directors) and the other employees are responsible for achieving the stated objectives through proper risk management and internal controls in their areas of responsibility.

The Municipal Finance Management Act 65 of 2003 (MFMA), which came into effect on 1 July 2004, applies to all municipalities and municipal entities. It also applies to national and provincial governments, departments and public entities, to the extent that they have financial dealings with municipalities. The Act aims to modernise budget and financial management practices, to ensure greater transparency and accountability in the finances of municipalities, and to put in place a sound financial governance framework. The MFMA is the local government equivalent of the Public Finance Management Act (PFMA), which applies to the national and provincial spheres of government. The MFMA focuses on performance through setting and monitoring outputs, outcomes and measurable objectives, which is where internal auditing has a role to play.

The responsibility of the internal auditor is derived from the definition of internal auditing, which requires that the internal auditor evaluate and improve the effectiveness of the governance process used by the organisation in a systematic and disciplined manner.

The JSE Securities Exchange requires listed companies to comply with some of the recommendations of King III, and the PFMA and MFMA stipulate that all the organisations in the public sector must comply with the recommendations of the King report. This creates a substantial demand for internal audit in South Africa, especially professionally certified individuals.

The third King Report on Governance in South Africa (King III) became necessary because of the anticipated new Companies Act and changes in international governance trends. The King III Code, as in the case of King I and II, is based on the "explain" principle. Directors are required to "apply" the code or "explain" the reasons for not doing so. King III, however, applies to all entities regardless of the manner and form of incorporation or establishment. The new Companies Act became operative on 1 July 2010 and the King III report became effective from 1 September 2009.

At the time that this study material was compiled, in South Africa two universities offered a BCom degree with specialisation in internal auditing, namely, Unisa and the University of Pretoria. In addition, most universities of technology in South Africa offer a three-year diploma in internal auditing and a four-year BTech degree in internal auditing.

1.2.3 DEVELOPMENT OF THE THEORETICAL BASIS FOR INTERNAL AUDITING

The theory of any discipline is contained in its definition and the analysis and explanation of the elements contained in the definition. The definition is the foundation of the theoretical exposition, because the definition must clearly stipulate the objectives, the boundaries of the discipline and the methodology required to attain the objectives.

It follows logically from this that the development of the theory goes hand in hand with the development of the elements of the discipline. In this context "development" means an account of the historical course of events from which internal auditing, as we know it today, originated. A few fundamental concepts of internal auditing have been identified and defined, and these can be accepted as part of the theory of internal auditing.

These fundamental concepts have been arrived at through the study of the objectives and methodology of internal auditing, and they represent an important evolution in the theory of the discipline. We will discuss them in more detail in Part C of this module.

Certain of the sub-objectives and methodological aspects of internal auditing overlap with those of external auditing, and so theories developed for the field of external auditing may also be applicable to internal auditing. The following concepts, which form part of external auditing theory, and which we will analyse and describe in greater detail throughout the study guide, are equally applicable to internal auditing:

- independence,
- due care,
- ethical conduct and
- audit evidence.

In addition, there are descriptions and analyses of the methodology of external auditing. The methodology of internal and external auditing correspond in some important respects, and we could say that in this regard the theory of internal auditing has developed to the same extent as that of external auditing.

As we said earlier, the objectives and practice of internal auditing have been changing since it first emerged as a discipline, which implies a corresponding development in the theoretical basis of internal auditing.

The first formal contribution by the international professional body for internal auditors was the publication in 1972 of the first formal requirements for a common body of knowledge for internal auditors.

The two main components of this required body of knowledge were the following:

1. identifying the most important disciplines of which internal auditors should acquire a thorough knowledge

2. identifying the level of knowledge required in each of these disciplines

The first level of knowledge involves understanding of terminology and facts.

The second level of knowledge involves a thorough understanding of the general aspects of auditing practice and procedures.

The third level of knowledge, which is the highest level, involves a thorough understanding and knowledge of principles, practice and procedures at a high level of competency.

Answer the questions below.

1. What were the main components in establishing the required body of knowledge for internal auditors?

2. List the criteria that are generally regarded as the main characteristics of a profession.

Question 1
- The identification of the most important disciplines of which internal auditors should have a thorough understanding.
- The required levels of knowledge in each of these disciplines.

Question 2
- Specialised knowledge of a subject which should be acquired through formal training.

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- The rendering of a specialised service to society.

- Admission to the profession must be subject to predefined standards governing professional qualifications and experience.

- Society must accept and recognise the professional status of the profession, and the members of the profession must in turn acknowledge and recognise their social responsibility in the practice of their profession, that is, through their ethical code.

- Minimum standards should be set for the behaviour of members of the profession towards clients, colleagues and the public in the practice of their profession.

- Members must be organised in the context of an association which enjoys statutory recognition.

- The discipline and profession must have a common body of knowledge.
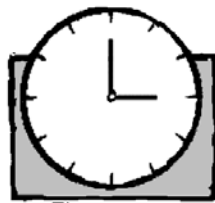
TOPIC SUMMARY

This topic introduced the concept of internal auditing. We examined the definition of internal auditing, which gives rise to the principal focus areas of the profession. We provided a concise account of how the elements of internal auditing developed from the emergence of the discipline up to the present.

Now that you have worked through this topic, are you able to:

- explain the theoretical concepts underlying internal auditing in the context of the technical vocabulary associated with internal auditing by the use of context- specific examples?
- analyse the definition of internal auditing?
- describe the objective of an internal audit engagement in relation to the service provided to the organisation?
- describe the main focus areas of an internal audit engagement in terms of the definition of internal auditing?
- describe the misconceptions of internal auditing?
- describe the origin and development of internal auditing in terms of the development of the theoretical basis, professionalism and practice of internal auditing?

TOPIC 2: THE FUNCTIONAL ROLE OF INTERNAL AUDITING

INTRODUCTION AND PURPOSE OF THE TOPIC

In this topic the functions of management of an organisation and the place and role of the internal audit activity in an organisation are described.

LEARNING OUTCOMES

When you have worked through this topic, you should be able to

- describe the functions of management in an organisation.
- demonstrate the functions of the internal auditor in an organisation in terms of the context of the technical vocabulary associated with internal auditing and the audit process.
- explain the position of the internal audit activity in the organisational plan of an undertaking and the relationship with other parties in the organisation.
- illustrate the different roles of the internal audit activity in an organisation in terms of the Standards.
- identify the advantages associated with an internal audit activity as well as the need for internal auditing with reference to the internal audit process and the nature of internal audit work.

CONTENT OF THE TOPIC

This topic is made up of the following learning units:

Learning unit	Title
2.1	The functions of management in an organisation
2.2	The functions and role of the internal auditor in an organisation

LEARNING UNIT 2.1: THE FUNCTIONS OF MANAGEMENT IN AN ORGANISATON

2.1.1 BACKGROUND

In the internal auditing environment we often refer to concepts such as "management", "management's duties" and "managerial function", and it is necessary to begin by briefly examining these concepts. Management science is an independent field of study, which comprises a number of subfields.

Our objective in this section is merely to outline, as a background, some basic concepts within the framework of management that an internal auditor often encounters and of which he/she should have knowledge.

Management implies authority, especially in respect of policy formulation and decision making. The characteristics of authority are logical thinking, rational actions, the use of all operational aids, methods and techniques as well as clear communication of policies and decisions from the top downwards through the various ranks, accompanied by reporting and accountability upwards along the same line of seniority.

Management is responsible for the progress maintenance and functioning of the organisation, through adequate planning, organising, directing and control. Before internal auditors can maximise their assistance, however, they must fully understand each four of the management functions and how the work of the internal auditor can provide vital support in each area.

The four functions of management are the following:

. Planning

. Organising

. Directing

. Controlling

These four functions will now be discussed in more detail:

PLANNING

Planning relates to the main purpose(s) of the organisation and includes the setting of both short-term and long-term objectives. It requires knowledge of or research into the technological aspects of the business that the organisation is in, the physical and mechanical resources available, the operating methods, techniques or strategies, and policy and the staff situation. All of these elements must be considered within the limits imposed by the capacity and marketing potential of the products that the organisation manufactures or trades in, or the service that the organisation renders. Organising, directing and controlling should always be planned properly in advance to ensure the most harmonious relationship possible between these basic elements of successful management.

Sawyer and Dittenhofer (2003) have the following to say about the planning function of management:

> *Planning precedes all other management functions. It is necessarily the first of the four functions of management, because from plans flow organisation, direction, and control. Every organisation must fit the plans of the entity. All direction is pointed at moving people toward planned objectives and goals. All controls should be designed to make sure that plans will be carried out* ***effectively***, ***efficiently***, *and* ***economically***.

All planning is strategic or tactical. Strategic planning is long range, whereas tactical planning is short range. A primary purpose of strategic planning is to help managers cope with future contingencies. It involves developing the organisational mission and objectives, and the means to achieve them. Strategic plans include tax planning, capital budgeting, personnel planning, and product planning. Tactical plans relate to the day-to-day operations of the enterprise; production scheduling is an example.

Planning involves managers at all levels of the organisation. Plans are decisions to take certain steps. However, they should be flexible, adjusting to circumstances. If they are to be successful, they should be coordinated among functions and cost effective.

Planning addresses a number of management fundamentals, such as setting and determining the following:

- mission, that is, the basic function or task of an organisation.

- objectives and goals of the organisation that guide the enterprise toward its mission.

- authoritative direction and control (governance) of the organisation, of which risk management is an important aspect.

- strategies that implement the objectives and are the broad, overall concepts of an operation.

- principles that are general guides for action.

- policies that are general guides, namely, individual thinking for action.

- procedures are specific guides that prescribe action, a sequence of steps to accomplish a task.

- rules are the simplest form of plans, which must be followed as stated and allow for no discretion. Standards are norms against which activities are measured.

- premises are the assumptions on which plans are based.

- budgets give quantitative expression to an entity's plans.

- decision making is problem solving. It is a planning function and is therefore future-oriented.

ORGANISING

Organising brings together people and processes in logical groupings to carry out plans and meet objectives. Good organisation is no guarantee of success, but poor organisation will almost inevitably bring about failure, because it breeds conflict and frustration.

Organisation charts show the structure of the organisation. However, they illustrate only a small part of an executive's activities and interfaces. Since they are static representations, they need to be revised constantly if the organisation is dynamic. They may imply what is not stated, namely that departments on the same level of the hierarchy do not have the same status. Some executives feel that organisation charts do more harm than good because of the danger of misinterpretation, rigidity, and the failure to record changing and complex relationships.

Organisation charts do have benefits, however: they can show the chain of command – the hierarchy, accountability, and responsibility of the organisation's executives. They can be designed to show the basic function of each position, and they do provide a valuable overview of the organisation.

The following basic management concepts fall under "organising":

- Responsibility, the obligation to perform.
- Authority, the right to perform, to command, to enforce compliance, derived from responsibility.
- Accountability, the obligation of workers and managers to give a reckoning/feedback and take responsibility for what they have accomplished or failed to accomplish, derived from responsibility.
- Delegation includes assigning responsibility, granting authority, and exacting accountability.
- Span of Control refers to the number of subordinates a supervisor can efficiently and effectively manage.
- Staff and Line – Line people make "line decisions". Staff people advise them. Functional authority is the assignment of some of the chief executive's authority to a staff organisation or an individual.
- Departmentalisation divides the organisation into distinct groupings to perform assigned tasks.
- Decentralisation divides large complex organisations into smaller business units that are relatively compact and simple.
- Committees, a committee is a group of people who work together on some aspect of a management function.
- Informal groups are composed of unstructured relationships among members that disregard the organisation chart.
- Staffing includes personnel planning and recruiting, and selecting and developing people to operate the organisation competently.

DIRECTING

Directing or guidance, as a management function represents the following:

- Communication of organisational or managerial policy to subordinates, especially heads of departments

- The communication of goals and strategies through procedural manuals (or the holding of staff meetings or even the establishment of guidance committees)

- The motivation of staff so that they adhere to managerial policy. Because of the practice of delegation, the most important aspect of directing is the communication along a descending line of authority of information regarding general procedures, goals, objectives and strategies.

- Directing is also dependent upon knowledge of what is happening at the operating levels. All forms of reporting, but especially reporting of operational and accounting information, are essential elements since directing involves decision making, adaptation to changing circumstances, and the resulting reformulation of policy, goals and strategies. A continuous two-way flow of information is needed, which ensures feedback from the bottom up as input for management; this in turn leads to a top-down flow of guidelines or policies to ensure a continuous adjustment of operations to reach objectives.

Sawyer and Dittenhofer (2003:p1085) define directing as:

the function of moving resources toward objectives and goals. Successful directing depends on the motivation of those directed. The reason why people are motivated to perform well is based on many complex factors. These include their background and training, the group with which they work, and the work situation itself.

Early theories of directing were founded on the classical school of thought, and grew out of the military concept of a commander issuing orders. This changed with the advent of the behavioural school. Effective leadership was seen as stemming from acceptance by subordinates of the leader and their willingness to obey. Executives must find the link between the individual's needs and those of the organisation, and achieve a harmony between them. Authority is effective only if subordinates accept it.

CONTROL

Control over all forms of delegated duties is not only a managerial aid, but is actually the achievement of efficient and successful management.

Control is associated with achieving the following objectives:

- Ensuring adherence to managerial policy
- Ensuring correct utilisation of all physical, mechanical and supervisory resources
- Achieving compliance with planned procedures
- Ensuring obedience to the rules regarding documentation and authorisation
- Achieving the delimitation of executive powers in the decentralised and delegated areas of authority
- Setting minimum standards of compliance
- Measuring results against expected standards
- Introducing and maintaining an efficient system of internal accounting controls
- Achieving efficient reporting on all activities

Management's control functions endorse their involvement and responsibilities regarding the entire undertaking and all its business operations.

Sawyer & Dittenhofer (2003:p1093–1099) define controlling as:

the process of making certain that directed action is carried out as planned to achieve some desired objective or goal. Controlling and planning are linked. Indeed, controlling cannot operate effectively without the tools provided by planning. Some devices, such as budgets, are used both to plan and to control.

Control is exercised by managers at all levels, from chief executive officer to floor supervisor. Different terms have been used to describe various forms of control – these include management control, executive control, administrative control, financial control, and accounting control. However, they all refer to the same function; the difference lies in the objectives they are designed to meet.

Control can be described as a closed system consisting of a series of six main elements:

1. Setting performance standards to provide a means of measuring and comparing events and establishing permissible variations.

2. Measuring performance or progress to   accumulate information on existing conditions.

3. Analysing performance or progress and comparing it with standards to determine variances.

4. Evaluating deviations and bringing them to appropriate attention to determine causes, and effective corrective action.

5. Correcting deviations from standards to see that objectives and goals will be met.

6. Following up on corrective action to determine its effectiveness.

In conclusion, we can say that planning, organising, directing and control are the distinguishing subprocesses of active management. The success with which they are applied is reflected in the results achieved. These results, in turn, are the measures of the effectiveness with which management has discharged its responsibilities. When examining and evaluating the organisation's operations, the internal auditor should take each of these subprocesses into account.

LEARNING UNIT 2.2: THE FUNCTIONS AND ROLE OF THE INTERNAL AUDITOR IN AN ORGANISATION

INTRODUCTION

In this learning unit we discuss in detail what is expected of an internal auditor and his or her relationship with all levels of management. We will be covering:

1. the position of the internal audit activity in the organisational structure of an undertaking.

2. the role of the internal audit activity in an organisation.

3.   the need for and advantages of an internal audit.

2.2.1 THE PLACE OF THE INTERNAL AUDIT ACTIVITY IN THE ORGANISATIONAL STRUCTURE OF AN ENTITY

The internal audit activity should be an integral part of the organisation, and should function under the policies established by executive management and the board. Internal audit is accountable to both the board and executive management, providing them with reasonable assurance regarding the effectiveness of the company's corporate governance, risk management processes and systems of internal control. In addition, as a consulting activity, internal audit adds value and recommends improvements where opportunities arise to do so.

An important element in the success of an internal audit activity is the extent of support and acceptance it enjoys from top management and the board. It is unlikely that the internal audit activity will receive the necessary support and acceptance from the rest of the staff if top management and the board do not support it. This makes support from and acceptance at the highest level extremely important to the internal auditor.

In both the USA and SA there is an encouraging tendency toward greater involvement and interest in the internal audit activity on the part of the board and top management. This indicates a greater acceptance by the board and top management of the internal audit activity as a valuable tool, resulting in turn in increased support for internal audit.

Internal auditors should take full advantage of the opportunities offered by increased contact with the board and top management. In doing this they will improve their knowledge and skills with a view to rendering a more efficient service. This, in turn, should lead to even greater acceptance and support for internal auditors throughout the organisation.

Internal auditors render a service to the management and the board of directors of an organisation. However, we need to remember that internal auditors work for and are paid by the organisation, and it is vital that they maintain their independence. This creates a challenge.

In view of this situation, do you think it is possible for internal auditors to be totally independent?

No, in fact it isn't, but internal auditors must nevertheless strive to achieve the greatest measure of independence possible in the situation in which they find themselves.

How can internal auditors be **independent**?

The IPPF Standards 1100 states:

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

Organisational policy, reflected in the status of the internal audit activity within the organisation, should guarantee independence and it should be upheld by the professional conduct of the auditors.

Therefore, the fact that internal auditors may be employees of the company does not in itself impair their objectivity.

The IPPF Standard 1100 interpretation states as follows with regard to independence and objectivity:

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 organisational 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 organisational levels.

So, what does independence mean for internal auditors?

Independence means that internal auditors

- must not be involved in or be responsible for any performance matters within an activity being audited
- must be able to develop auditing programmes without being influenced

- must have full access to all evidence and members of staff wherever this is required for the purposes of the audit
- must be objective in collecting and evaluating information and evidence
- must be able to prepare audit reports on any matters they consider necessary

Independence consists of the two important elements:

a. organisational independence of an internal audit activity and
b. individual objectivity

a. Organisational independence of an internal audit activity

An organisation that recognises the importance of placing the internal audit function at a level that would maximise its effectiveness and be able to evaluate the efficacy of the risk management, controls and governance processes that are in place, often do so through appointing a senior management position described in the IIA Standards as a CAE. The Chief Audit Executive (CAE) is a senior employee within the organisation, who is the head of the internal audit function and is responsible for internal audit activities.

The organisational independence of the internal audit activity is directly influenced by the following two factors:

- The level of responsibility conferred on the internal audit activity within the organisation, which naturally reflects the value that management attach to the work performed by the internal auditors. This is an indicator of the degree of acceptance by top management of the role played by the internal auditors.
- The level of management to which the CAE, as the head of the internal audit activity, reports. This is an indicator of the internal auditor's degree of access to top management.

The "organisational plan" refers to the plan according to which management groups together organisational units or departments whose activities are compatible, in order to create a logical flow of operations for the transfer, or taking over, of duties and responsibilities at specified strategic points so that the objectives of the undertaking can be achieved and the management policy carried out as smoothly and efficiently as possible.

To establish the correct organisational status of the internal audit activity, the organisational plan must be carefully constructed, and the position of internal audit must allow the internal auditors to be independent.

The following Standard describes how organisational independence should be established within the internal audit activity. The Standards do not prescribe any fixed solution, but they do require that the organisational level of the internal audit activity should be such that internal auditors enjoy the necessary access to and support from executive management to enable them to carry out their duties free from interference and to obtain the cooperation of the auditees. The Practice Advisories related to this Standard describe what is meant by the Standard and provide further guidance on how the requirements may be met.

Standard 1110 – Organisational Independence

> *The chief audit executive must report to a level within the organisation that allows the internal audit activity to fulfil its responsibilities. The chief audit executive must confirm to the board, at least annually, the organisational independence of the internal audit activity.*

Interpretation:

Organisational 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;

- 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; 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 Practice Advisory gives more guidance on the recommended reporting structure and what these reporting lines would entail:

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 organisation's chief executive officer, facilitates organisational independence. At a minimum the CAE needs to report to an individual in the organisation 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 organisational 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 organisation'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.

b.   Individual objectivity of the internal auditor

Because internal auditors must be independent of the activities they audit, it is unlikely that they will be able to function optimally if the internal audit activity is grouped together with another activity, regardless of how compatible these activities may appear to be. The objectivity of the internal auditor could be impaired.

In most organisations, experience has shown that in cases where the internal auditor is also responsible for performing executive tasks, he or she attends to these tasks first, to the detriment of the internal audit activities. In these cases, one could question the objectivity of the internal auditor with regard to these executive tasks, as there is a conflict of interests

On the other hand, where the internal auditor audits full-time, but reports to more than one individual, the problem is that the internal audit activity as a whole might be uncoordinated. The internal audit activity, therefore, becomes less effective and disadvantages associated with fragmented responsibility may be experienced.

In practice, the most effective results are obtained where the internal audit activity operates as a separate independent department. This hierarchical classification is in line with the International Standards for the Professional Practice of Internal Auditing.

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 fulfil 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.

The Practice Advisory gives more guidance on what is permissible and could impair an internal audit individual's objectivity:

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 judgements.

2. Individual objectivity involves the chief audit executive (CAE) organising 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 by an audit supervisor or senior 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.

The Impairment to Independence or Objectivity Standard 1130 states that

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.

Interpretation:

Impairment to organisational 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.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.

2.2.1.1   Possible reporting lines for the internal audit activity

The decision to whom the CAE should report is vital for the effectiveness of the internal audit activity's independence. In practice we find that the CAE may report to any or a combination of the management functions listed below:

1.   Governing body – board of directors/control board/committee

2.   Top executive management

3.   Chief Executive Officer (CEO)

4.   Chief Financial Officer (CFO)

5.   Audit Committee (as a subcommittee of the Board of Directors)

The advantages and disadvantages of each of these forms of reporting, as well as the compromise method of dual reporting, are discussed in greater detail below.

1.   Governing body – board of directors/control board/committee AND top executive management

Direct reporting to the top executive management (board of directors or managing director) holds great advantages for the independence and accessibility of the internal audit activity. The following question, however, arises in this case: What is the primary purpose of the internal audit activity in an undertaking? Is it the rendering of assistance as a service to management or is it to serve as a control over management?

If the primary accent is on rendering assistance and a service to management, it is logical that the internal audit activity should fall under the guidance and control of management and should, therefore, report to them.

A compromise (dual reporting) could be agreed upon and the chief audit executive of internal auditing would then report to

•   the board of directors regarding functional responsibilities

•   executive management regarding (operational) matters

An important aspect to bear in mind when reporting to top executive management is that other members of management may mistrust the internal auditor because of his or her access to top executive management, and that he or she may therefore not be acceptable to them as a member of the management team. This distrust originates because other members of management might perceive the influence and authority of the internal auditor arising from his or her high status and level of reporting as a threat to their own positions. For this reason the internal auditor might face resistance as a fellow member of the management team. The

importance of direct access to top executive management and the audit committee is, however, described in Standard 1110 of the International Standards for the Professional Practice of Internal Auditing, and the increased independence which the internal auditor obtains through direct access is also discussed.

2. Chief Executive Officer (CEO)

Initially, advantages of this level of reporting are that:

- It guarantees access to a high-level official.

- It provides a reasonable measure of independence for the internal auditor. (In big undertakings the CEO is not normally responsible for a particular department.)

- Management may feel less threatened because the accessibility of the internal auditor is at a lower level than if he were to report to the Board of Directors (see 1). The distrust with which management may regard the internal auditor might thus be reduced by this particular level of reporting.

However, there are the following disadvantages:

- If the influence and authority of the internal auditor is such that audit matters receive the attention of the CEO, to the detriment of other management matters, the efficiency of management will suffer and distrust might increase.

- Since a CEO is normally very busy, the CAE might find that he or she does not receive the guidance and support necessary to perform his or her task effectively. Reporting to the CEO may, therefore, not be the ideal reporting structure for internal auditors.

3. Chief Financial Officer (CFO)

The internal audit activity traditionally reported to the CFO because approximately half the time spent in internal auditing was devoted to the auditing of financial aspects of the undertaking.

In practice this line of reporting works well. The most important to be considered in this case is the level of responsibility and authority of the CFO. If it is too low, the internal auditors will find it difficult to perform their duties free of interference and to obtain the cooperation of auditees. Low-level access does not afford the internal auditors the necessary status.

When referring to the CFO we do not mean the financial accountant. The organisational independence of the internal auditor would be affected if he were to report to the chief accountant because the chief accountant would be able to suspend the audit activities of the internal auditor

as soon as weaknesses in activities under his control were pointed out. The internal audit activity would not have the necessary authority and status to deal effectively with other heads of departments.

Although reporting to t h e CFO is common, the disadvantage for the internal auditor is a certain loss of independence, because he o r s h e could possibly be manipulated by the finance department, particularly if his or her involvement in financial matters is taken into account. Other departments, such as production, may feel that they are open to criticism, whereas the finance department is able to avoid this.

4. The audit committee

An audit committee is a committee comprising persons outside the organisation (directors from other companies, consultants, non-affiliated officials) with specialised knowledge, responsible for serving as a link between the governing body/top executive management and the external and internal auditors in all matters pertaining to auditing.

This level of reporting gives the internal audit activity a high degree of organisational independence and accessibility because it is reporting to a body with more authority than top executive management, and the majority of members are not involved in the operational matters of the company (executive functions). The involvement of the audit committee with the appointment and discharge of the chief audit executive is also advocated in the professional standards. This will be dealt with in more detail in Topic 9.

In practice, however, the following problems are experienced with this channel of reporting:

1. Because the audit committee does not meet frequently enough, they do not have the time to support the internal audit activity on a day-to-day basis as an independent reporting facility. Audit committees meet on average four times a year.

2. Because of its function, the audit committee, by its very nature, is apart from the main stream of business activities. As a result, the internal auditor does not always receive necessary information and directives which might enable him to function effectively.

3. The audit committee also has a functional rather than an operational role and it is, therefore, undesirable that members should be involved with the operational or household details of the internal audit activity. Their proper functions would include the final authorisation of audit plans and audit findings, the coordination of audit efforts and the formulation of audit policy.

Any restrictions placed on the internal auditor by management should, however, be brought to their attention by the internal auditor for final resolution. As a result of these problems, sole reporting to the audit committee is not currently common practice.

5. Dual reporting

Owing to the limitations of each of the reporting lines described above, a compromise arrangement is normally made in practice, whereby the chief audit executive has a dual level of reporting. The chief audit executive reports,

1. to the audit committee on **functional** responsibilities
2. to the CEO on **operational/household** tasks such as reviewing budgets, requests for salary increases and staff expansion.

Also refer to learning unit 9.1.5 of the study guide with regard to the relationship of the internal auditor with the audit committee.

Dual reporting takes place when a particular management function reports to more than one management authority. Examples of dual reporting were discussed under 1 and 4 above.

The disadvantages of a divided line of reporting are the following:

1. The possibility of manipulation by all the parties.
2. It is essential to clearly demarcate and enforce the responsibilities of the parties to whom the audit activity reports, especially where the parties are not on the same organisational level and therefore do not have the same organisational status and authority.
3. There is a possibility that an internal audit manager with dual reporting responsibility may be pulled in two directions as a result of a difference of opinion between the parties to whom he or she reports.

2.2.2 THE ROLE OF THE INTERNAL AUDIT ACTIVITY IN AN ORGANISATION

As discussed in Topic 1, the International Standards for the Professional Practice of Internal Auditing (Standards), the IIA defines the role of the internal audit activity in an undertaking in the definition of internal auditing as follows:

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.

Internal audit activities are performed in diverse legal and cultural environments; within organisations that vary in purpose, size, and structure; and by persons within or outside the organisation. These differences may affect the practice of internal auditing in each environment. However, compliance with the Standards is essential if the responsibilities of internal auditors are to be met.

The objective of internal auditing is to **assist** members of executive and senior management in the effective discharge in their duties and responsibilities with regard to risk management; control and governance (refer to 1.1.3). To this end, internal audit furnishes them with analyses, appraisals, recommendations, counsel and information concerning the activities reviewed. The management of the organisation sets the objectives and goals. These plans or objectives are designed to ensure the success of the organisation. To accomplish these plans the managers must ensure the successful attainment of the goals, which will ultimately lead to the attainment of the objectives.

Therefore it is the internal auditors' duty to help managers to ensure that their plans actually do achieve what they want them to achieve. This is how internal auditors add value to the organisation and help it to run more smoothly.

An effective internal audit activity should provide management with:

- assurance that the management processes are adequate to identify and monitor significant risks;
- confirmation of the effective operation of the established internal control system;
- credible processes for feedback on risk management and assurance; and
- objective confirmation that the board receives the right quality of assurance and information from management and that this information is reliable.

To do this, the internal auditor fulfils both an advisory and a control function, which we will now discuss further.

2.2.2.1 The internal auditor as adviser to members of the organisation

Internal auditors examine and review the activities of the undertaking in order to understand and evaluate them and form an opinion on the effectiveness of such activities. These opinions are then used to furnish members of the organisation with advice, information and recommendations that will enable them to discharge their duties effectively.

As adviser the internal auditor must form an unbiased opinion and it is for this reason that the internal audit activity is defined as an independent, objective assurance and consulting activity and grouped as such in the organisational structure of the undertaking.

As an adviser he or she merely **offers advice**, **gives information or makes recommendations**. This means that the **ultimate decision** whether or not to accept this advice or information or to implement these recommendations, therefore **always rests with executive management**.

Please Note:

The internal audit activity should never possess the organisational power to force top executive management to accept the audit results.

Furthermore, internal auditors should never take responsibility to implement their recommendations as an adviser; they need to stay independent from the activities they review.

The internal auditor is responsible only for following up to ascertain that a decision relating to his or her recommendations has been taken. Management may decide to:

1. accept the internal auditor's recommendations, in which case the internal auditor must ascertain that the corrective action taken is achieving the desired results, or
2. reject his or her recommendations, in which case the internal auditor should ascertain that top executive management has assumed the risk associated with failure to take corrective action on reported findings.

Managers are often unaware of the benefits that their internal auditors can offer. This may be because the internal auditors have not educated management about those benefits. Internal auditors practice be staffed with people with different educational background (such as CA(SA)'s, lawyers, engineers, etc.)

Internal auditors can therefore assist management in:

* monitoring activities top management can't itself monitor;
* identifying and minimising risks;
* validating reports to senior management;
* protecting senior management in technical areas beyond its knowledge;
* providing information for the decision-making process;
* reviewing for the future as well as for the past; and
* helping line managers manage by pointing to violations of procedures and of management principles.

Here are some brief examples of this assistance to management:

Monitoring activities. Each year a chief audit executive prepares a schedule of proposed audits that specify the activities to be monitored. These are presented to executive management and the board and can be adjusted to meet the needs of senior officials.

Identifying and minimising risks. Many internal audit activities identify the more serious risks to the enterprise that they come across in the daily execution of their work. These may include such diverse matters as controls over master keys, employee bonuses, blank checks, and rotation and vacations of employees in key positions to more strategic risks such as the impact of changes in the regulatory environment. The items on this list are referenced to the regular audits scheduled to be carried out. Internal auditors make sure that the risks and the controls over them have been thoroughly examined.

Validating reports to senior management. Senior managers make their decisions on the basis of reports to them – not usually on matters of personal knowledge. Accurate, timely reports are more likely to produce knowledgeable decisions. Some audit activities compile lists of such executive reports and reference them to scheduled audits. When such audits are done, the auditors review the reports for accuracy, timeliness, and meaningfulness. Management decisions are then more likely to be valid as the information on which decision-making is based, has been independently verified by the internal auditor.

Protecting management in technical fields. The growing complexity of business and government affairs bring with it certain matters that may be beyond the scope of the manager who must decide on them.

Helping in the decision-making process. Managers, not internal auditors, are responsible for making operating decisions. However, internal auditors can supply or validate the data on which those decisions are made. Also, they can evaluate the effects of decisions made and point out risks that were not anticipated, and make recommendations in the decision-making process based on their knowledge and experience.

Reviewing for the future as well as the past. The US General Accounting Office has pioneered what are termed programme audits. In terms of this approach they assessed policies or programmes still in the design stage, the implementation of a policy or programme, and the actual results achieved by a policy or programme. Also, computer literate internal auditors appraise controls over proposed information systems before they are implemented. It can be very expensive if all the necessary controls are not incorporated before a system is implemented, and adjustments need to be made afterwards.

Helping managers manage. Managers who are not in control of their activities develop problems. The internal auditors generally find the problems and suggest corrections. Those corrections, however, can be just quick fixes or they can reach the roots of the problems and improve management as well. The latter is always the most desirable, and internal audit recommendations should always aim to address the root- cause of any problem.

2.2.2.2   The internal auditor as a control function

The internal audit activity serves as a detective control in the system of internal control, in other words it functions as a control over other controls.

The scope of the task of the internal audit activity in an undertaking includes the examination and evaluation, by the internal auditor, of the adequacy and effectiveness of risk management, control, and governance processes and the quality of performance in carrying out assigned responsibilities (Practice Advisory 2100-1).

In this capacity the internal audit activity evaluates the general system of management control and the system of internal control, and keeps top executive management informed regarding the adequacy of the system.

The aim of evaluating the adequacy of the organisation's existing governance, risk management and control processes is to determine whether the established system provides reasonable assurance that the objectives and goals of the organisation will be achieved efficiently and economically. In the course of this process the internal audit also determines whether policy, standards and procedures are being carried out as laid down by management.

The aim of evaluating the effectiveness of governance, risk management and control processes is to determine whether the system is dependable, that is whether objectives and goals are being accomplished in an accurate and timely fashion with minimal use of resources.

Finally, the quality of performance in carrying out assigned responsibilities is evaluated in order to determine whether the objectives of the undertaking have in fact been achieved.

Where deviations or problems with the above exist, internal audit detects and reports on this. In this sense, internal audit is a control function.

2.2.3 THE ADVANTAGES OF THE INTERNAL AUDIT ACTIVITY IN AN ORGANISATION

2.2.3.1   The need for internal auditing

The safeguarding of assets, reliability of financial records and efficiency in operations are basic responsibilities of the management of an organisation and are primary objectives of accounting and administrative controls. Management is increasingly aware of the advantage of having an internal audit activity to assist in fulfilling such responsibilities.

You are probably wondering why a company needs internal auditors to add value and improve its operations when these functions are clearly the responsibility of management.

Shareholders appoint directors to manage the company on their behalf. Due to growth in our society, managers need the assistance of internal auditors simply because their organisations have complex activities, the volumes of transactions are high and dependence on large numbers of people creates operational problems. The managers need assurance that their plans are executed correctly throughout the organisation and that all employees in the organisation at all levels comply with the rules of the organisation and perform their responsibilities properly. This is where internal audit plays an important role to help the organisation (by communicating to management) achieve its objectives.

Complex organisations create a need for different levels of management and together with the internal audit activity ensures that the company as a whole works together at achieving the same goals which have been formulated by top management.

The need to establish an internal audit activity in an organisation can further be motivated as follows:

- Many organisations are a blend of business and non-business activities and these developments increase the need for internal auditing in all types of organisations where

the complexity of the activities, the volume of transactions, and the dependence of large numbers of people create operational challenges.

- Whenever organisational responsibilities are established there is a potential need for internal auditing services to give assurance that those responsibilities are executed as planned.

- The safeguarding of assets, reliability of financial records and efficiency in operations are basic responsibilities of management and are primary objectives of accounting and administrative controls. Management is increasingly aware of the advantages of having an internal audit activity to assist in monitoring such responsibilities.

2.2.3.2   The advantages for internal auditing

The most important advantage offered by regular exposure of the activities of an organisation to an internal audit is closely linked to the purpose of an internal audit, namely the assistance rendered to the management of the organisation to help them attain their objectives.

Other advantages:

1. The internal audit report provides management with the assurance that management policy, standards and procedures are satisfactory; that they are being executed and adhered to; and that the risk management, control and governance processes are adequate and effective.

2. Any deviations or discrepancies or unsatisfactory aspects from which deductions for re-organisation, adaptation or correction could be made, are timeously brought to management's attention.

3. The internal auditor's report assures management that management data whether operational or financial information, are compiled in a consistent, uniform and standardised manner. This forms the basis for the proper interpretation of the information and the true evaluation of the operational results and the financial state of affairs of the organisation for further analyses in order to arrive at meaningful management decisions.

4. There is always a possibility of discovering fraud and errors when continuous evaluation of the internal control is carried out by internal auditors, which is of the utmost importance to management.

5. The advantages associated with the possibility of exposing fraud and errors include the moral influence an internal audit may have on the work and behaviour of personnel. The moral influence lies in three spheres:
   o The staff are likely to keep their work up to date and file vouchers systematically, which leads to more efficient work performance.
   o There should be an improvement in the diligence, accuracy and neatness of work performed by the staff.
   o An audit would certainly discourage inclinations toward slackness, negligence and dishonesty.

6. Unexpected visits by the internal auditor will also provide an element of surprise, not only strengthening the moral influence, but also reducing the time available for the staff to cover up or rectify fraud and errors. If staff know that their work will not be subjected to an impartial and objective review by a competent person, this is certainly more conducive to errors and dishonesty in connection with money, merchandise and books of account than would have been the case had they been aware of the fact that a critical and searching internal audit of their activities was soon to follow.

7. The quality and contents of the internal audit report offer management a mechanism to apply in evaluating the internal audit activity itself.

8. The internal audit report offers the auditee an instrument for the evaluation of his own work performance, and for the timely correction of problems. Internal auditors also make recommendations, thereby assisting the auditee to correct or improve the operations audited.

9. The productive use of all available resources is ensured, enabling the organisation to achieve its stated objectives.

10. It enables the enterprise to evaluate its working procedures and to rectify any problems in a timely manner.

Note that the advantages of an internal audit are also determined by the type of organisation and the maturity of its systems and processes. Shareholders, suppliers and customers will for example also benefit by improved operations. In conclusion, we again emphasise that any professed advantage must always be subordinate to and closely associated with the objective of internal auditing

Answer the questions below.

Question 1

1.   Which of the following alternatives is not one of the four functions of management?

   A.   Reviewing.

   B.   Organising.

   C.   Directing.

   D.   Planning.

Question 2

Briefly explain the place of the internal audit activity in the organisational structure of an organisation.

Question 1

This question required you to know the four functions of management and select the option that was not a function of management.

Option A is correct as reviewing is not a function of management. Reviewing forms part of control.

Options B, C and D are incorrect as planning, organising, directing and controlling are the four functions of management.

Question 2

For the purpose of establishing the correct organisational status of the internal audit activity, it is important that the organisational plan of an entity is carefully constructed and that the position of the internal audit activity allows the internal auditors to be independent.

The *Standards* describe how organisational independence should be established within the internal audit activity. They require that the internal auditors enjoy the necessary access to and

support from executive management to enable them to carry out their duties free from interference and to obtain the cooperation of the auditees.

Standard 1110 states that the chief audit executive must report to a level within the organisation that allows the internal audit activity to fulfil its responsibilities. The chief audit executive (CAE) reporting functionally to the board and administratively to the organisation's chief executive officer facilitates organisational independence. The CAE should report to an individual with sufficient authority to promote independence and ensure broad audit coverage, adequate consideration of engagement communications, and appropriate action on engagement recommendations. The internal audit activity should be independent of the activities audited and internal auditors should be objective in performing their work. The fact that internal auditors may be employees of the company does not, of itself, impair their objectivity.

TOPIC SUMMARY

Learning unit 2.1 revised the four generally accepted management functions of any organisation, namely, planning, organising, directing and control, are dealt with in this learning unit. They represent an extremely important component of the internal auditor's field of knowledge, because the effectiveness and efficiency with which the management of any organisation performs these functions is the central issue in any internal audit. The four management functions are an important component of the theory of internal auditing, which will be dealt with in more detail in another part of this module. You need to understand the composition and role of each function thoroughly. Without this level of knowledge you will not be able to conduct a professional internal audit successfully.

In learning unit 2.2, the role and function of the internal auditor in an organisation was explained. It is very important for the internal auditor to know exactly what his or her function is and the basis from which he or she can operate, namely, what his or her organisational position is and what his or her relationships with other parties are.

Now that you have worked through this topic, are you able to:

- describe the functions of management in an organisation?

- demonstrate the functions of the internal auditor in an organisation in terms of the context of the technical vocabulary associated with internal auditing and the audit process?

- explain the position of the internal audit activity in the organisational plan of an undertaking and the relationship with other parties in the organisation?

- illustrate the different roles of the internal audit activity in an organisation in terms of the Standards?

- identify the advantages associated with an internal audit activity as well as the need for internal auditing with reference to the internal audit process and the nature of internal audit work?

TOPIC 3: PROFESSIONAL MATTERS PERTAINING TO INTERNAL AUDITING

INTRODUCTION AND PURPOSE OF THE TOPIC

In this topic we give you an overview of the International Professional Practices Framework (IPPF), specifically the Code of Ethics and the International Standards for the Professional Practice of Internal Auditing (Standards).

LEARNING OUTCOMES

When you have worked through this topic, you should be able to

- give account of the purpose and content of the International Professional Practice Framework (IPPF) for internal auditors.
- apply the Code of Ethics in practical context-specific examples.
- describe the purpose and requirements of the International Standards for the Professional Practice of Internal Auditing (Standards) in terms of the conduct of an internal auditing engagement.

CONTENT OF THE TOPIC

This topic is made up of the following learning units:

Learning unit	Title
3.1	Introduction to the International Professional Practices Framework (IPPF)
3.2	The Institute of Internal Auditors (IIA) Code of Ethics
3.3	International Standards for the Professional Practice of Internal Auditing (Standards)

LEARNING UNIT 3.1: INTRODUCTION TO THE INTERNATIONAL PROFESSIONAL PRACTICES FRAMEWORK (IPPF) FOR INTERNAL AUDITORS

The International Professional Practices Framework (IPPF) is the conceptual framework that organises authoritative guidance formulated by the Institute of Internal Auditors (IIA). The IIA provides internal audit professionals throughout the world with authoritative guidance. In the IPPF this guidance is divided into two categories, namely **mandatory** and **strongly recommended** guidance.

The IPPF includes the following elements:

1.   The Definition of Internal Auditing

2.   The Code of Ethics

3.   The International Standards for the Professional Practice of Internal Auditing (Standards)

4.   Practice Advisories

5.   Position Papers

6.   Practice Guides

Adherence to the IPPF is **mandatory** or **strongly recommended**:

Mandatory – Compliance is required and is essential for all members of the Institute of Internal Auditors and the guidance is developed following due processes, which includes public exposure. Compliance with the principles set forth in mandatory guidance is essential for the professional practice of internal auditing.

OR

Strongly recommended – Compliance is strongly recommended for members and the guidance is endorsed by the IIA through a formal review and approval process. It describes practices to implement the Code of Ethics and Standards effectively.

The following illustration (developed by the Institute of Internal Auditors' Research Foundation – IIARF) indicates which component/element of the IPPF is mandatory or strongly recommended.

Figure 3.1:   The International Professional Practices Framework (IPPF)

The table below provides a brief explanation of the elements of the IPPF, based on information supplied by the IIARF:

Element	Definition
Definition of Internal Auditing	Statement of fundamental purpose, nature and scope of internal auditing.
International Standards	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 at organisational and individual levels. • Interpretations, which clarify terms or concepts within the statements.

	• Glossary terms. Both Statements and Interpretations must be understood and applied correctly.
Code of Ethics	The Code of Ethics states the: • principles and expectations governing the behaviour of individuals and organisations in the conduct of internal auditing. • the minimum requirements for conduct, and • behavioural expectations rather than specific activities.
Practice Advisories	• Practice advisories assist internal auditors in applying the mandatory guidance and promoting best practices. • They address internal auditing's approach, methodologies, and consideration, but do not detail processes or procedures. • They include practices relating to international, country, or industry-specific issues, specific types of engagements, and legal or regulatory issues.
Position Papers	These papers assist a wide range of interested parties; including those **not** in the internal audit profession, in understanding significant governance, risk, or control issues, and delineating the related roles and responsibilities of internal auditing.
Practice Guides	• They provide detailed guidance for conducting internal audit activities. • They include processes and procedures, tools and techniques, programs, and step-by-step approaches, as well as examples of deliverables.

Please make sure that you **study and memorise** the above figure and table so that you know them by heart and will be able to give account of the information at any time. This knowledge is

imperative to your understanding, interpretation and implementation of the IPPF throughout your studies of internal auditing and in your career as an internal auditor.

Read the IIA's strongly recommended guidance (i.e. Position Papers, Practice Advisories and Practice Guides).

(http://www.theiia.org/guidance/standards-and-guidance/)

LEARNING UNIT 3.2: THE INSTITUTE OF INTERNAL AUDITORS (IIA) CODE OF ETHICS

Ethical conduct is an important requirement for the practice of any profession. 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 related to risk, control and governance in an organisation. It helps to formulate the moral principles which should be observed by members of the Institute of Internal Auditors. The provisions of the Code of Ethics cover the basic principles in internal auditing practice.

Members should understand that individual judgement is required in the application of these principles. Internal auditors are responsible for conducting themselves in such a way that their good faith and integrity are beyond question. The Code of Ethics imposes a responsibility on internal auditors to display a high degree of professional care in the execution of their duties. Internal auditors have a responsibility to the profession of internal auditing, management, the shareholders and the general public, and so they should act accordingly based on set principles.

The Definition of internal auditing as mentioned in Learning unit 1 is as follows:

"Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."

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

1.   **Principles** that are relevant to the profession and practice of internal auditing.

2. **Rules of Conduct** that describe behavioural 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 members of the Institute of Internal Auditors (IIA), recipients of or candidates for IIA professional certifications (such as the CIA), 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 individuals **AND** entities that perform internal audit services.

In the case of 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 action 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 may be liable for disciplinary action.

The Code of Ethics provides guidance to internal auditors in executing their responsibilities. The Code also gives four rules of conduct that guide internal auditors in terms of how the principles would be put into internal audit practice.

The Code of Ethics (reproduced below) are concise and clear and require no further explanation.

Study the Code of Ethics and make sure that you are able to explain and apply it.

<u>**Principles**</u>

Internal auditors are expected to apply and uphold the following four 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 audit 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 organisation.

1.4. Shall respect and contribute to the legitimate and ethical objectives of the organisation.

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 organisation.

2.2. Shall not accept anything that may impair or be presumed to impair their professional judgment.

2.3. Shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review.

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 organisation.

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 audit services in accordance with the *International Standards for the Professional Practice of Internal Auditing (Standards).*

4.3. Shall continually improve their proficiency and the effectiveness and quality of their services.

State, with reasons, whether or not the following action of the internal auditor is a breach of the Code of Ethics:

John Khumalo, a junior internal audit staff member, discussed with his friends the incidence of fraud he had discovered during his audit of the company's debtors.

This is a violation of the Integrity and Confidentiality principles in the Code of Ethics. Mr. Khumalo is guilty of misconduct.

Integrity (par 1.1) - Internal auditors shall perform their work with honesty, diligence, and responsibility.

Confidentiality (par 3.1) - Internal auditors shall be prudent in the use and protection of information acquired in the course of their duties.

This was a violation since John had no legal obligation to divulge this information.

LEARNING UNIT 3.3: INTERNATIONAL STANDARDS FOR THE PROFESSIONAL PRACTICE OF INTERNAL AUDITING (STANDARDS)

The Standards are one of the mandatory elements of the IPPF. They are principle-focused and provide a framework for performing and promoting internal auditing.

The purpose of the Standards is to:

1. delineate basic principles that represent the practice of internal auditing.

2. provide a framework for performing and promoting a broad range of value-added internal auditing.

3. establish the basis for the evaluation of internal audit performance.

4. foster improved organisational processes and operations.

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

*   **Statements** of basic requirements for the professional practice of internal auditing and for evaluating the effectiveness of performance, which are internationally applicable at organisational and individual levels.
*   **Interpretations**, which clarify terms or concepts within the Statements.

The Standards are divided into **Attribute**, **Performance** and **Implementation** Standards. The Attribute and Performance Standards apply to all internal audit services.

The following table provides an overview of the characteristics of these Standards:

Table 2: Overview of the Attribute and Performance Standards

Attribute Standards	Performance Standards
Standards that address the characteristics of organisations and parties performing internal audit activities.	Standards that describe the nature of internal audit activities and provide quality criteria against which the performance of these services can be evaluated.
The 1000 Series	The 2000 Series
1000:Purpose, Authority, and Responsibility 1100:Independence and objectivity 1200:Proficiency and due professional care 1300:Quality assurance and improvement programme	2000: Managing the internal audit activity 2100: Nature of the work 2200: Engagement planning 2300: Performing the engagement 2400: Communicating results 2500: Monitoring progress 2600: Resolution of management's acceptance of risks.

The Implementation Standards expand upon the Attribute and Performance *Standards*, by providing guidance applicable to assurance (A) or consulting (C) activities and specific types of engagements (e.g. a compliance audit, a fraud investigation or a control self-assessment project).

Assurance services involve the internal auditor's objective assessment of evidence to provide an independent opinion or conclusions regarding an entity, operation, function, process, system, or other subject matter. The nature and scope of the assurance engagement are determined by the internal auditor. There are generally three parties involved 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.

There is one set of Attribute and Performance Standards, but there will be multiple sets of Implementation Standards: a set for each of the major types of internal audit activity. Currently, the Implementation Standards are established for assurance activities (denoted by an "A" following the Standard number, e.g., 1130.A1) and consulting activities (denoted by a "C" following the Standard number, e.g., nnnn.C1).
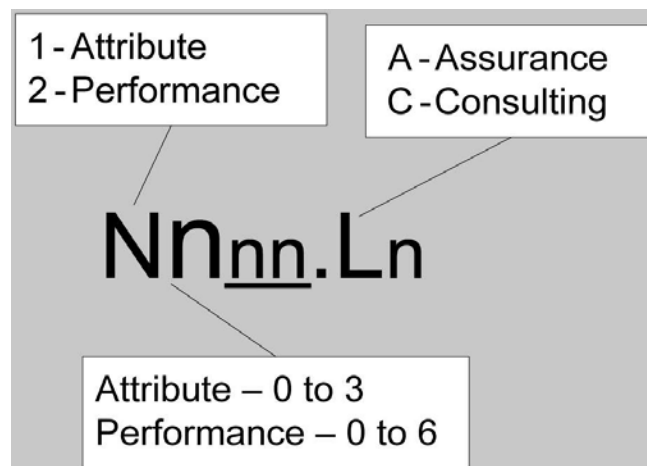
The Standards employ terms that have been given specific meanings. These are explained in the Glossary at the end of this learning unit.

The contents of these Standards are extensive. To fully understand the nature and scope of internal auditing you will **need a thorough knowledge and understanding of all the Standards.** The Standards are more than just a set of rules and regulations for internal auditors. They do not merely consist of an account of what internal auditors are required to do.

A thorough analysis of the Standards shows that they also explain both directly and indirectly, why Standards are necessary and why they should be followed. This perspective on the Standards forms an important part of the theoretical basis of internal auditing because it provides the rationale or explanation for the conduct of internal auditors.

You must study the Practice Advisories to understand and be able to interpret the Standards that are mandatory. Remember that Practice Advisories cover approach, methodology and

considerations, but not detailed processes and procedures. They act to explain and expand on how internal auditors can apply Standards. Practice Advisories are constantly being added and amended.

Please access the IIA website for updates at www.theiia.org/guidance

The other category of guidance (Development & Practice Aids) includes a variety of materials that are developed and/or endorsed by the IIA. This category includes research studies, books, seminars, conferences, and other products and services related to the professional practice of internal auditing that do not meet the criteria for inclusion in Mandatory Guidance, but may be very useful for internal auditors in executing their responsibilities.

In this module we deal with the Standards briefly and in general terms. At the third study level we will give you the details of what the Standards prescribe. Therefore, we will concentrate on explanations of the Standards, that is, on the why – the objectives – which are dealt with in the section on the theoretical basis of internal auditing, rather than on the literal content of the instructions governing conduct and procedures, which represents the practical perspective on the Standards. Eventually you will have to know and understand both these aspects, but you will reach this point only after the third study level.

INTERNATIONAL STANDARDS FOR THE PROFESSIONAL PRACTICE OF INTERNAL AUDITING (STANDARDS)

ATTRIBUTE STANDARDS

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 Definition of Internal Auditing, the Code of Ethics, and the Standards. The chief audit executive must periodically review the internal audit charter and present it to senior management and the board for approval.

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 organisation, including the nature of the chief audit executive's functional reporting relationship with the board; **authorises 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.*

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

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 Definition of Internal Auditing, the Code of Ethics, and the *Standards* must be recognized in the internal audit charter. The chief audit executive should discuss the Definition of Internal Auditing, the Code of Ethics, and the Standards with senior management and the board.

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 organisational 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 organisational levels.

1110 – Organisational Independence

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

Interpretation:

Organisational 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.

1111 – Direct Interaction with the Board
The chief audit executive must communicate and interact directly with the board.

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 fulfil 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.

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.

Interpretation:

Impairment to organisational 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.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.

1200 – Proficiency and Due Professional Care

Engagements must be performed with proficiency and due professional care.

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:

Knowledge, skills, and other competencies is a collective term that refers to the professional proficiency required of internal auditors to effectively carry out their professional responsibilities. 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 organisations.

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 organisation, 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.

1220 – Due Professional Care

Internal auditors must apply the care and skill expected of a reasonably prudent and competent internal auditor. Due professional care does not imply infallibility.

1220.A1 – Internal auditors must exercise due professional care by considering the:

- Extent of work needed to achieve the engagement's objectives;

- Relative complexity, materiality, or significance of matters to which assurance procedures are applied;

- Adequacy and effectiveness of governance, risk management, and control processes;

- Probability of significant errors, fraud, or noncompliance; and

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- Cost of assurance in relation to potential benefits.

1220.A2 – In exercising due professional care internal auditors must consider the use of technology-based audit and other data analysis techniques**.**

1220.A3 – Internal auditors must be alert to the significant risks that might affect objectives, operations, or resources. However, assurance procedures alone, even when performed with due professional care, do not guarantee that all significant risks will be identified.

1220.C1 – Internal auditors must exercise due professional care during a consulting engagement by considering the:

- Needs and expectations of clients, including the nature, timing, and communication of engagement results;

- Relative complexity and extent of work needed to achieve the engagement's objectives; and

- Cost of the consulting engagement in relation to potential benefits.

1230 – Continuing Professional Development

Internal auditors must enhance their knowledge, skills, and other competencies through continuing professional development.

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.

1310 – Requirements of the Quality Assurance and Improvement Program

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

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 organisation 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.

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 organisation. 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 organisations 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 organisation to which the internal audit activity belongs.

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.

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.

1322 – Disclosure of Non-conformance

When non-conformance 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 non-conformance and the impact to senior management and the board.

PERFORMANCE STANDARDS

2000 – Managing the Internal Audit Activity

The chief audit executive must effectively manage the internal audit activity to ensure it adds value to the organisation.

Interpretation:

The internal audit activity is effectively managed when:

- *The results of the internal audit activity's work achieve the purpose and responsibility included in the internal audit charter;*

- *The internal audit activity conforms with the Definition of Internal Auditing and the Standards; and*

- *The individuals who are part of the internal audit activity demonstrate conformance with the Code of Ethics and the Standards.*

The internal audit activity adds value to the organisation (and its stakeholders) when it provides objective and relevant assurance, and contributes to the effectiveness and efficiency of governance, risk management, and control processes.

2010 – Planning

The chief audit executive must establish a risk-based plan to determine the priorities of the internal audit activity, consistent with the organisation's goals.

Interpretation:

The chief audit executive is responsible for developing a risk-based plan. The chief audit executive takes into account the organisation's risk management framework, including using risk appetite levels set by management for the different activities or parts of the organisation. If a framework does not exist, the chief audit executive uses his/her own judgment of risks after consideration of input from senior management and the board. The chief audit executive must

review and adjust the plan, as necessary, in response to changes in the organisation's business, risks, operations, programs, systems, and controls.

2010.A1 – The internal audit activity's plan of engagements must be based on a documented risk assessment, undertaken at least annually. The input of senior management and the board must be considered in this process.

2010.A2 – The chief audit executive must identify and consider the expectations of senior management, the board, and other stakeholders for internal audit opinions and other conclusions.

2010.C1 – The chief audit executive should consider accepting proposed consulting engagements based on the engagement's potential to improve management of risks, add value, and improve the organisation's operations. Accepted engagements must be included in the plan.

2020 – Communication and Approval

The chief audit executive must communicate the internal audit activity's plans and resource requirements, including significant interim changes, to senior management and the board for review and approval. The chief audit executive must also communicate the impact of resource limitations.

2030 – Resource Management

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

Interpretation:

Appropriate refers to the mix of knowledge, skills, and other competencies needed to perform the plan. Sufficient refers to the quantity of resources needed to accomplish the plan. Resources are effectively deployed when they are used in a way that optimizes the achievement of the approved plan.

2040 – Policies and Procedures

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

Interpretation:

The form and content of policies and procedures are dependent upon the size and structure of the internal audit activity and the complexity of its work.

2050 – Coordination

The chief audit executive should share information and coordinate activities with other internal and external providers of assurance and consulting services to ensure proper coverage and minimize duplication of efforts.

2060 – Reporting to Senior Management and the Board

The chief audit executive 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.

Interpretation:

The frequency and content of reporting are determined in discussion with senior management and the board and depend on the importance of the information to be communicated and the urgency of the related actions to be taken by senior management or the board.

2070 – External Service Provider and Organisational Responsibility for Internal Auditing

When an external service provider serves as the internal audit activity, the provider must make the organisation aware that the organisation has the responsibility for maintaining an effective internal audit activity.

Interpretation

This responsibility is demonstrated through the quality assurance and improvement program which assesses conformance with the Definition of Internal Auditing, the Code of Ethics, and the Standards.

2100 – Nature of Work

The internal audit activity must evaluate and contribute to the improvement of governance, risk management, and control processes using a systematic and disciplined approach.

2110 – Governance

The internal audit activity must **assess** and **make appropriate recommendations** for improving the governance process in its accomplishment of the following objectives:

- Promoting appropriate ethics and values within the organisation;

- Ensuring effective organisational performance management and accountability;

- Communicating risk and control information to appropriate areas of the organisation; and

- Coordinating the activities of and communicating information among the board, external and internal auditors, and management.

2110.A1 – The internal audit activity must evaluate the design, implementation, and effectiveness of the organisation's ethics-related objectives, programs, and activities.

2110.A2 – The internal audit activity must assess whether the information technology governance of the organisation supports the organisation's strategies and objectives.

2120 – Risk Management

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

Interpretation:

*Determining whether risk management processes are effective is a judgment resulting from the internal auditor's **assessment** that:*

- *Organisational objectives support and align with the organisation's mission;*
- *Significant risks are identified and assessed;*
- *Appropriate risk responses are selected that align risks with the organisation's risk appetite; and*
- *Relevant risk information is captured and communicated in a timely manner across the organisation, enabling staff, management, and the board to carry out their responsibilities.*

The internal audit activity may gather the information to support this assessment during multiple engagements. The results of these engagements, when viewed together, provide an understanding of the organisation's risk management processes and their effectiveness.

Risk management processes are monitored through ongoing management activities, separate evaluations, or both.

2120.A1 – The internal audit activity must evaluate risk exposures relating to the organisation's governance, operations, and information systems regarding the:

- Achievement of the organisation's strategic objectives;

- Reliability and integrity of financial and operational information;

- Effectiveness and efficiency of operations and programs;

- Safeguarding of assets; and

- Compliance with laws, regulations, policies, procedures, and contracts.

2120.A2 – The internal audit activity must evaluate the potential for the occurrence of fraud and how the organisation manages fraud risk.

2120.C1 – During consulting engagements, internal auditors must address risk consistent with the engagement's objectives and be alert to the existence of other significant risks.

2120.C2 – Internal auditors must incorporate knowledge of risks gained from consulting engagements into their evaluation of the organisation's risk management processes.

2120.C3 – When assisting management in establishing or improving risk management processes, internal auditors must refrain from assuming any management responsibility by actually managing risks.

2130 – Control

The internal audit activity must assist the organisation in maintaining effective controls by evaluating their effectiveness and efficiency and by promoting continuous improvement.

2130.A1 – The internal audit activity must evaluate the adequacy and effectiveness of controls in responding to risks within the organisation's governance, operations, and information systems regarding the:

- Achievement of the organisation's strategic objectives;

- Reliability and integrity of financial and operational information;

- Effectiveness and efficiency of operations and programs;

- Safeguarding of assets; and

- Compliance with laws, regulations, policies, procedures, and contracts.

2130.*C*1 – Internal auditors must incorporate knowledge of controls gained from consulting engagements into evaluation of the organisation's control processes.

2200 – Engagement Planning

Internal auditors must develop and document a plan for each engagement, including the engagement's objectives, scope, timing, and resource allocations.

2201 – Planning Considerations

In planning the engagement, internal auditors must consider:

- The objectives of the activity being reviewed and the means by which the activity controls its performance;

- The significant risks to the activity, its objectives, resources, and operations and the means by which the potential impact of risk is kept to an acceptable level;

- The adequacy and effectiveness of the activity's governance, risk management, and control processes compared to a relevant framework or model; and

- The opportunities for making significant improvements to the activity's governance, risk management, and control processes.

2201.A1 – When planning an engagement for parties outside the organisation, internal auditors must establish a written understanding with them about objectives, scope, respective responsibilities, and other expectations, including restrictions on distribution of the results of the engagement and access to engagement records.

2201.C1 – Internal auditors must establish an understanding with consulting engagement clients about objectives, scope, respective responsibilities, and other client expectations. For significant engagements, this understanding must be documented.

2210 – Engagement Objectives

Objectives must be established for each engagement.

2210.A1 – Internal auditors must conduct a preliminary assessment of the risks relevant to the activity under review. Engagement objectives must reflect the results of this assessment.

2210.A2 – Internal auditors must consider the probability of significant errors, fraud, noncompliance, and other exposures when developing the engagement objectives.

2210.A3 – Adequate criteria are needed to evaluate governance, risk management, and controls. Internal auditors must ascertain the extent to which management and/or the board has established adequate criteria to determine whether objectives and goals have been accomplished. If adequate, internal auditors must use such criteria in their evaluation. If inadequate, internal auditors must work with management and/or the board to develop appropriate evaluation criteria.

2210.C1 – Consulting engagement objectives must address governance, risk management, and control processes to the extent agreed upon with the client.

2210.C2 – Consulting engagement objectives must be consistent with the organisation's values, strategies, and objectives.

2220 – Engagement Scope

The established scope must be sufficient to achieve the objectives of the engagement.

2220.A1 – The scope of the engagement must include consideration of relevant systems, records, personnel, and physical properties, including those under the control of third parties.

2220.A2 – If significant consulting opportunities arise during an assurance engagement, a specific written understanding as to the objectives, scope, respective responsibilities, and other expectations should be reached and the results of the consulting engagement communicated in accordance with consulting standards.

2220.C1 – In performing consulting engagements, internal auditors must ensure that the scope of the engagement is sufficient to address the agreed-upon objectives. If internal auditors develop reservations about the scope during the engagement, these reservations must be discussed with the client to determine whether to continue with the engagement.

2220.C2 – During consulting engagements, internal auditors must address controls consistent with the engagement's objectives and be alert to significant control issues.

2230 – Engagement Resource Allocation

Internal auditors must determine appropriate and sufficient resources to achieve engagement objectives based on an evaluation of the nature and complexity of each engagement, time constraints, and available resources.

2240 – Engagement Work Program

Internal auditors must develop and document work programs that achieve the engagement objectives.

> **2240.A1 –** Work programs must include the procedures for identifying, analysing, evaluating, and documenting information during the engagement. The work program must be approved prior to its implementation, and any adjustments approved promptly.

> **2240.C1 –** Work programs for consulting engagements may vary in form and content depending upon the nature of the engagement.

2300 – Performing the Engagement

Internal auditors must identify, analyse, evaluate, and document sufficient information to achieve the engagement's objectives.

2310 – Identifying Information

Internal auditors must identify sufficient, reliable, relevant, and useful information to achieve the engagement's objectives.

Interpretation*:*

Sufficient information is factual, adequate, and convincing so that a prudent, informed person would reach the same conclusions as the auditor. Reliable information is the best attainable information through the use of appropriate engagement techniques. Relevant information supports engagement observations and recommendations and is consistent with the objectives for the engagement. Useful information helps the organisation meet its goals.

2320 – Analysis and Evaluation

Internal auditors must base conclusions and engagement results on appropriate analyses and evaluations.

2330 – Documenting Information

Internal auditors must document relevant information to support the conclusions and engagement results.

2330.A1 – The chief audit executive must control access to engagement records. The chief audit executive must obtain the approval of senior management and/or legal counsel prior to releasing such records to external parties, as appropriate.

2330.A2 – The chief audit executive must develop retention requirements for engagement records, regardless of the medium in which each record is stored. These retention requirements must be consistent with the organisation's guidelines and any pertinent regulatory or other requirements.

2330.C1 – The chief audit executive must develop policies governing the custody and retention of consulting engagement records, as well as their release to internal and external parties. These policies must be consistent with the organisation's guidelines and any pertinent regulatory or other requirements.

2340 – Engagement Supervision

Engagements must be properly supervised to ensure objectives are achieved, quality is assured, and staff is developed.

Interpretation:

The extent of supervision required will depend on the proficiency and experience of internal auditors and the complexity of the engagement. The chief audit executive has overall responsibility for supervising the engagement, whether performed by or for the internal audit activity, but may designate appropriately experienced members of the internal audit activity to perform the review. Appropriate evidence of supervision is documented and retained.

<u>2400 – Communicating Results</u>

Internal auditors must communicate the results of engagements.

2410 – Criteria for Communicating

Communications must include the engagement's objectives and scope as well as applicable conclusions, recommendations, and action plans.

2410.A1 - Final communication of engagement results must, where appropriate, contain the internal auditors' opinion and/or conclusions. When issued, an opinion or conclusion

must take account of the expectations of senior management, the board, and other stakeholders and must be supported by sufficient, reliable, relevant, and useful information.

Interpretation: *Opinions at the engagement level may be ratings, conclusions, or other descriptions of the results. Such an engagement may be in relation to controls around a specific process, risk, or business unit. The formulation of such opinions requires consideration of the engagement results and their significance.*

2410.A2 – Internal auditors are encouraged to acknowledge satisfactory performance in engagement communications.

2410.A3 – When releasing engagement results to parties outside the organisation, the communication must include limitations on distribution and use of the results.

2410.C1 – Communication of the progress and results of consulting engagements will vary in form and content depending upon the nature of the engagement and the needs of the client.

2420 – Quality of Communications

Communications must be accurate, objective, clear, concise, constructive, complete, and timely.

Interpretation:

Accurate communications are free from errors and distortions and are faithful to the underlying facts. Objective communications are fair, impartial, and unbiased and are the result of a fair-minded and balanced assessment of all relevant facts and circumstances. Clear communications are easily understood and logical, avoiding unnecessary technical language and providing all significant and relevant information. Concise communications are to the point and avoid unnecessary elaboration, superfluous detail, redundancy, and wordiness. Constructive communications are helpful to the engagement client and the organisation and lead to improvements where needed. Complete communications lack nothing that is essential to the target audience and include all significant and relevant information and observations to support recommendations and conclusions. Timely communications are opportune and expedient, depending on the significance of the issue, allowing management to take appropriate corrective action.

2421 – Errors and Omissions

If a final communication contains a significant error or omission, the chief audit executive must communicate corrected information to all parties who received the original communication.

2430 – Use of "Conducted in Conformance with the International Standards for the Professional Practice of Internal Auditing"

Internal auditors may report that their engagements are "conducted in conformance with the *International Standards for the Professional Practice of Internal Auditing*", only if the results of the quality assurance and improvement program support the statement.

2431 – Engagement Disclosure of Non-conformance

When non-conformance with the Definition of Internal Auditing, the Code of Ethics or the *Standards* impacts a specific engagement, communication of the results must disclose the:

- Principle or rule of conduct of the Code of Ethics or *Standard(s)* with which full conformance was not achieved;

- Reason(s) for non-conformance; and

- Impact of non-conformance on the engagement and the communicated engagement results.

2440 – Disseminating Results

The chief audit executive must communicate results to the appropriate parties.

Interpretation:

The chief audit executive is responsible for reviewing and approving the final engagement communication before issuance and for deciding to whom and how it will be disseminated. When the chief audit executive delegates these duties, he or she retains overall responsibility.

2440.A1 – The chief audit executive is responsible for communicating the final results to parties who can ensure that the results are given due consideration.

2440.A2 – If not otherwise mandated by legal, statutory, or regulatory requirements, prior to releasing results to parties outside the organisation the chief audit executive must:

- Assess the potential risk to the organisation;

- Consult with senior management and/or legal counsel as appropriate; and

- Control dissemination by restricting the use of the results.

2440.C1 – The chief audit executive is responsible for communicating the final results of consulting engagements to clients.

2440.C2 – During consulting engagements, governance, risk management, and control issues may be identified. Whenever these issues are significant to the organisation, they must be communicated to senior management and the board.

2450 – Overall Opinions

When an overall opinion is issued, it must take into account the expectations of senior management, the board, and other stakeholders and must be supported by sufficient, reliable, relevant, and useful information.

Interpretation:

The communication will identify:

- *The scope, including the time period to which the opinion pertains;*

- *Scope limitations;*

- *Consideration of all related projects including the reliance on other assurance providers;*

- *The risk or control framework or other criteria used as a basis for the overall opinion; and*

- *The overall opinion, judgment, or conclusion reached.*

- *The reasons for an unfavourable overall opinion must be stated.*

2500 – Monitoring Progress

The chief audit executive must establish and maintain a system to monitor the disposition of results communicated to management.

2500.A1 – The chief audit executive must establish a follow-up process to monitor and ensure that management actions have been effectively implemented or that senior management has accepted the risk of not taking action.

2500.C1 – The internal audit activity must monitor the disposition of results of consulting engagements to the extent agreed upon with the client.

2600 – Communicating the Acceptance of Risks

When the chief audit executive concludes that management has accepted a level of risk that may be unacceptable to the organisation, the chief audit executive must discuss the matter with senior management. If the chief audit executive determines that the matter has not been resolved, the chief audit executive must communicate the matter to the board.

Interpretation:

The identification of risk accepted by management may be observed through an assurance or consulting engagement, monitoring progress on actions taken by management as a result of prior engagements, or other means. It is not the responsibility of the chief audit executive to resolve the risk.

Glossary

Add Value
The internal audit activity adds value to the organisation (and its stakeholders) when it provides objective and relevant assurance, and contributes to the effectiveness and efficiency of governance, risk management, and control processes.

Adequate Control
Present if management has planned and organized (designed) in a manner that provides reasonable assurance that the organisation's risks have been managed effectively and that the organisation's goals and objectives will be achieved efficiently and economically.

Assurance Services
An objective examination of evidence for the purpose of providing an independent assessment on governance, risk management, and control processes for the organisation. Examples may include financial, performance, compliance, system security, and due diligence engagements.

Board
The highest level of governing body charged with the responsibility to direct and/or oversee the activities and management of the organisation. Typically, this includes an independent group of directors (e.g., a board of directors, a supervisory board, or a board of governors or trustees). If such a group does not exist, the "board" may refer to the head of the organisation. "Board" may refer to an audit committee to which the governing body has delegated certain functions.

Charter
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 organisation; authorises access to records, personnel, and physical properties relevant to the performance of engagements; and defines the scope of internal audit activities.

Chief Audit Executive

Chief audit executive describes a person in a senior position responsible for effectively managing the internal audit activity in accordance with the internal audit charter and the Definition of Internal Auditing, the Code of Ethics, and the *Standards.* The chief audit executive or others reporting to the chief audit executive will have appropriate professional certifications and qualifications. The specific job title of the chief audit executive may vary across organisations.

Code of Ethics

The Code of Ethics of The Institute of Internal Auditors (IIA) is Principles relevant to the profession and practice of internal auditing, and Rules of Conduct that describe behaviour expected of internal auditors. The Code of Ethics applies to both parties and entities that provide internal audit services. The purpose of the Code of Ethics is to promote an ethical culture in the global profession of internal auditing.

Compliance

Adherence to policies, plans, procedures, laws, regulations, contracts, or other requirements.

Conflict of Interest

Any relationship that is, or appears to be, not in the best interest of the organisation. A conflict of interest would prejudice an individual's ability to perform his or her duties and responsibilities objectively.

Consulting Services

Advisory and related client service activities, the nature and scope of which are agreed with the client, are intended to add value and improve an organisation's governance, risk management, and control processes without the internal auditor assuming management responsibility. Examples include counsel, advice, facilitation, and training.

Control

Any action taken by management, the board, and other parties to manage risk and increase the likelihood that established objectives and goals will be achieved. Management plans, organizes, and directs the performance of sufficient actions to provide reasonable assurance that objectives and goals will be achieved.

Control Environment

The attitude and actions of the board and management regarding the importance of control within the organisation. The control environment provides the discipline and structure for the achievement of the primary objectives of the system of internal control. The control environment includes the following elements:

- Integrity and ethical values.

- Management's philosophy and operating style.

- Organisational structure.

- Assignment of authority and responsibility.

- Human resource policies and practices.

- Competence of personnel.

Control Processes

The policies, procedures (both manual and automated), and activities that are part of a control framework, designed and operated to ensure that risks are contained within the level that an organisation is willing to accept.

Engagement

A specific internal audit assignment, task, or review activity, such as an internal audit, control self-assessment review, fraud examination, or consultancy. An engagement may include multiple tasks or activities designed to accomplish a specific set of related objectives.

Engagement Objectives

Broad statements developed by internal auditors that define intended engagement accomplishments.

Engagement Opinion

The rating, conclusion, and/or other description of results of an individual internal audit engagement, relating to those aspects within the objectives and scope of the engagement.

Engagement Work Program

A document that lists the procedures to be followed during an engagement, designed to achieve the engagement plan.

External Service Provider

A person or firm outside of the organisation that has special knowledge, skill, and experience in a particular discipline.

Fraud

Any illegal act characterized by deceit, concealment, or violation of trust. These acts are not dependent upon the threat of violence or physical force. Frauds are perpetrated by parties and organisations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage.

Governance

The combination of processes and structures implemented by the board to inform, direct, manage, and monitor the activities of the organisation toward the achievement of its objectives.

Impairment

Impairment to organisational independence and individual objectivity may include personal conflict of interest, scope limitations, restrictions on access to records, personnel, and properties, and resource limitations (funding).

Independence

The freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner.

Information Technology Controls

Controls that support business management and governance as well as provide general and technical controls over information technology infrastructures such as applications, information, infrastructure, and people.

Information Technology Governance

Consists of the leadership, organisational structures, and processes that ensure that the enterprise's information technology supports the organisation's strategies and objectives.

Internal Audit Activity

A department, division, team of consultants, or other practitioner(s) that provides independent, objective assurance and consulting services designed to add value and improve an organisation's operations. The internal audit activity helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of governance, risk management and control processes.

International Professional Practices Framework

The conceptual framework that organizes the authoritative guidance promulgated by The IIA. Authoritative Guidance is comprised of two categories – (1) mandatory and (2) strongly recommended.

Must

The Standards use the word "must" to specify an unconditional requirement.

Objectivity

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.

Overall Opinion

The rating, conclusion, and/or other description of results provided by the chief audit executive addressing, at a broad level, governance, risk management, and/or control processes of the organisation. An overall opinion is the professional judgment of the chief audit executive based on the results of a number of individual engagements and other activities for a specific time interval.

Risk

The possibility of an event occurring that will have an impact on the achievement of objectives. Risk is measured in terms of impact and likelihood.

Risk Appetite

The level of risk that an organisation is willing to accept.

Risk Management

A process to identify, assess, manage, and control potential events or situations to provide reasonable assurance regarding the achievement of the organisation's objectives.

Should

The *Standards* use the word "should" where conformance is expected unless, when applying professional judgment, circumstances justify deviation.

Significance

The relative importance of a matter within the context in which it is being considered, including quantitative and qualitative factors, such as magnitude, nature, effect, relevance, and impact. Professional judgment assists internal auditors when evaluating the significance of matters within the context of the relevant objectives.

Standard

A professional pronouncement promulgated by the Internal Audit Standards Board that delineates the requirements for performing a broad range of internal audit activities, and for evaluating internal audit performance.

Technology-based Audit Techniques

Any automated audit tool, such as generalized audit software, test data generators, computerized audit programs, specialized audit utilities, and computer-assisted audit techniques (CAATs).

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Scenario 1

The CAE must report to a level in the organisation that allows the internal audit activity to fulfil its responsibilities. The CAE at Mautja Limited reports functionally to the board. List examples of functional reporting to the board.

Scenario 2

The board of Mautja Limited, are unsure of the internal audit activity's responsibilities regarding governance processes.

Scenario 3

Linda Modisha is the new audit manager for Mautja Limited, a company that manufactures heavy machinery. Linda is an industrial engineer with three years' work experience. She has recently been transferred to the company's internal audit department after having completed a number of internal auditing modules at Unisa. She is planning her first audit project, and she has asked you to assist her.

With reference to the International Standards for the Professional Practice of Internal Auditing (Standards), respond to these three scenarios.

Since these scenarios require you to refer to the Standards, please quote the relevant Standard in your answer in each case.

Scenario 1

Examples of functional reporting to the board are addressed in **Standards 1110 – Organisational Independence.**

Standard 1110

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.

Scenario 2

The internal audit activity's responsibilities regarding the governance processes are addressed in **Standard 2110 – Governance.**

Standard 2110

The internal audit activity must **assess** and make **appropriate recommendations** for improving the governance process in its accomplishment of the following objectives:

- Promoting appropriate ethics and values within the organisation;

- Ensuring effective organisational performance management and accountability;

- Communicating risk and control information to appropriate areas of the organisation; and

- Coordinating the activities of and communicating information among the board, external and internal auditors, and management.

The internal audit activity must **evaluate** the design, implementation, and effectiveness of the organisation's ethics-related objectives, programs, and activities.

The internal audit activity must **assess** whether the information technology governance of the organisation supports the organisation's strategies and objectives.

Scenario 3

In planning the engagement, Linda should consider **Standard 2201 –** *Planning considerations*:

- The objectives of the activity being reviewed and the means by which the activity controls its performance.
- The significant risks to the activity, its objectives, resources and operations, and the means by which the potential impact of risk is kept to an acceptable level.
- The adequacy and effectiveness of the activity's risk management and control processes compared to a relevant control framework or model.
- The opportunities for making significant improvements to the activity's risk management and control processes.

TOPIC SUMMARY

In this topic we gave you an introduction to the formal aspects of internal auditing, namely the International Professional Practices Framework, which includes the IIA's Code of Ethics and the International Standards for the Professional Practice of Internal Auditing. A thorough knowledge and understanding of the content of these two mandatory components of the International Professional Practices Framework (IPPF) is of the utmost importance, since along with the third component, the definition of internal auditing, they represent the foundation of internal auditing.

Now that you have worked through this topic, are you able to:

- give account of the purpose and content of the International Professional Practice Framework (IPPF) for internal auditors?
- apply the Code of Ethics in practical context-specific examples?
- describe the purpose and requirements of the International Standards for the Professional Practice of Internal Auditing (Standards) in terms of the conduct of an internal auditing engagement?

PART C: THE QUALIFICATIONS, CHARACTERISTICS, PURPOSE, RESPONSIBILITIES AND LIABILITIES OF AN INTERNAL AUDITOR

TOPIC 4: THE QUALIFICATIONS AND CHARACTERISTICS OF AN INTERNAL AUDITOR

INTRODUCTION AND PURPOSE OF THE TOPIC

Internal Auditing Standard 1200 requires that internal auditing engagements must be performed with proficiency and due professional care. You learnt in the previous topics that an internal auditor must add value and improve an organisation's operations. To be able to meet these high-level expectations, the internal auditor should possess certain knowledge and skills and should also exhibit certain characteristics. This topic covers these expectations in more detail.

LEARNING OUTCOMES

When you have worked through this topic, you should be able to

- describe the formal qualifications, knowledge, skills and competencies that an internal auditor should possess in order to carry out his or her professional duties.

- describe the personal characteristics that may be expected of an internal auditor.

CONTENT OF THE TOPIC

This topic is made up of the following learning units:

Learning unit	Title
4.1	The qualifications and skills of an internal auditor
4.2	Personal characteristics of an internal auditor

LEARNING UNIT 4.1: THE QUALIFICATIONS AND SKILLS OF AN INTERNAL AUDITOR

Knowledge and competency

1. An internal auditor should be capable of handling any internal audit situation with confidence and assessing the relevant accountability correctly in the light of the prevailing economic and specific business conditions. Internal Auditing Standard 1200 states that internal audit engagements must be performed with proficiency.

2. Internal auditors should, therefore, have a thorough knowledge of management principles, financial and management accounting and information systems.

3. They should also have experience in a great variety of systems, and complete competence in internal auditing.

Let us look at what the IPPF requires regarding proficiency:

Standard 1200 Proficiency and Due Professional Care

Engagements must be performed with proficiency and due professional care.

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:

Knowledge, skills, and other competencies is a collective term that refers to the professional proficiency required of internal auditors to effectively carry out their professional responsibilities. 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 organisations.

> **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 organisation, 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.

Practice Advisory 1210-1

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

- o 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.

- o Proficiency in accounting principles and techniques if internal auditors work extensively with financial records and reports.

- o Knowledge to identify the indicators of fraud.

- o Knowledge of key information technology risks and controls and available technology-based audit techniques.

- o 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.

- o 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 recognise the existence of problems or potential problems and to identify the additional research to be undertaken or the assistance to be obtained.

- o Skills in dealing with people, understanding human relations, and maintaining satisfactory relationships with engagement clients.

- o 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 organisation. 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.

Recommended qualifications for internal auditors

The internal auditing profession offers a certification programme, which has been specifically developed for internal auditors. This programme, which was developed in the USA in 1972, is known as the Certified Internal Auditor (CIA) programme, and is controlled by the International Institute of Internal Auditors. A person who has obtained the CIA qualification enjoys international recognition as a professionally qualified internal auditor.

The syllabus of this certification programme is based on research on the common body of knowledge which a skilled internal auditor should possess. Research on the common body of knowledge for internal auditing is conducted regularly in order to ensure that the programme keeps abreast of the latest developments and incorporate these into the knowledge and skills requirements for CIAs.

For more information on the current CIA examination syllabus access the web pages of the Institute of Internal Auditors at: www.iiasa.org.za and select "Certification".

In South Africa, the CIA qualification is also regarded as the only distinctive qualification for internal auditors.

However, as of beginning 2014 South Africa has introduced a compulsory learning pathway for those who want to attain the CIA designation. For candidates entering the CIA program for the **first time in 2014** have to first serve articles of Internal Audit Technician (IAT) and Professional Internal Auditor (PIA) before sitting for the international CIA exam.

The IAT and PIA Training Programs are comparable to "articles" or "training contracts" and consist of two elements:

• An **education component** supplementary to the workplace training facilitated by the IIA SA, which consists of several days' focused instruction spread over time to ensure minimum disruption of the normal working hours, and

- An **experience component** (workplace implementation of principles learned). Candidates are issued a Training Log Book and assigned mentors within their organisations to gather evidence of competence.

In cases where an individual **already has relevant experience** equivalent to what would have been obtained via the PTP program and the academic qualification, the candidate may apply to be assessed through a **Recognition of Prior Learning (RPL) process**.

This also provides a professional designation (IAT and PIA) for those who do not want to go all the way to the CIA. Another change is that the international CIA exam syllabus is now divided into 3 parts. The CIA qualification is highly recognised globally, and this is also true in South Africa, where the CIA is gaining in importance and demand.

Therefore in South Africa, a person is entitled to the CIA qualification when he/she meets the following requirements:

Candidates should be in possession of a B Degree with Internal Auditing or equivalent qualification to enter the IAT program. Candidates must have obtained the IAT designation before entering the PIA program. It would also be advantageous to have exposure to Financial Accounting and Business Management.

1. Successfully completed and passed the IAT and PIA programs.
2. Successfully passed all three parts of the International CIA examination set by the International Institute of Internal Auditors.
3. A good character, as attested to by a CIA or member through a character reference. This is one of the entrance requirements for the IAT program.

LEARNING UNIT 4.2: PERSONAL CHARACTERISTICS OF AN INTERNAL AUDITOR

Having to liaise with and advise senior and executive management regarding diverse aspects of an organisation can be challenging. Internal auditors should also be able to build relationships and create confidence throughout the organisation, while remaining independent and objective. To achieve this, the internal auditor should exercise due professional care (Standard 1220) which requires him or her to possess certain personal characteristics.

Standard 1220 – Due Professional Care states that internal auditors must apply the care and skill expected of a reasonably prudent and competent internal auditor. Due professional care does not imply infallibility

1220.A1 – Internal auditors must exercise due professional care by considering the:

- Extent of work needed to achieve the engagement's objectives;

- Relative complexity, materiality, or significance of matters to which assurance procedures are applied;

- Adequacy and effectiveness of governance, risk management, and control processes;

- Probability of significant errors, fraud, or noncompliance; and

- Cost of assurance in relation to potential benefits.

1220.A2 – In exercising due professional care internal auditors must consider the use of technology-based audit and other data analysis techniques**.**

1220.A3 – Internal auditors must be alert to the significant risks that might affect objectives, operations, or resources. However, assurance procedures alone, even when performed with due professional care, do not guarantee that all significant risks will be identified.

1220.C1 – Internal auditors must exercise due professional care during a consulting engagement by considering the:

- Needs and expectations of clients, including the nature, timing, and communication of engagement results;

- Relative complexity and extent of work needed to achieve the engagement's objectives; and

- Cost of the consulting engagement in relation to potential benefits.

Practice Advisory 1220-1

1. Due professional care calls for the application of the care and skill expected of a reasonably prudent and competent internal auditor in the same or similar circumstances. Due professional care is therefore appropriate to the complexities of the engagement being performed. Exercising due professional care involves internal auditors being alert to the possibility of fraud, intentional wrongdoing, errors and omissions, inefficiency, waste, ineffectiveness, and conflicts of interest, as well as being alert to those conditions and activities where irregularities are most likely to occur. This also involves internal auditors identifying inadequate controls and recommending improvements to promote conformance with acceptable procedures and practices.

2. Due professional care implies reasonable care and competence, not infallibility or extraordinary performance. As such, due professional care requires the internal auditor to conduct examinations and verifications to a reasonable extent. Accordingly, internal auditors cannot give absolute assurance that noncompliance or irregularities do not exist. Nevertheless, the possibility of material irregularities or noncompliance needs to be considered whenever an internal auditor undertakes an internal audit assignment.

To be able to comply with the requirements for Due Professional Care, in practice, an internal auditor should possess the following personal characteristics:

1. **Inquisitive awareness of new developments.** Insight into the technological influences on the applicable disciplines, together with an interest in learning more about matters in which he or she is not proficient or new developments.

2. **Good interpersonal relations.** Being part of the organisation, internal auditors should be able to maintain very good interpersonal relations. An internal auditor should have a pleasant personality, inspire confidence, speak convincingly and act

with authority. He or she should be able to persuade others to cooperate, be tactful in his or her behaviour, and win the confidence of both management and colleagues.

3. **Diligence and patience.** Internal auditors must be able to exercise patience. Repetitive and routine work, although monotonous, should not affect their attention and concentration. Whenever necessary, they should be capable of probing deeply into a matter and should never hesitate to ask questions about matters about which they are uncertain.

4. **Objectivity and confidence.** Internal auditors should have the courage of their convictions, and should not hesitate to criticise justly or disclose the truth. Moreover, they should not yield to pressure. In other words, they should not hesitate to follow the path of duty, in spite of possible conflicting interests. However, their conviction must always be supported by facts.

5. **Practical approach.** Internal auditors must be practical and never allow theoretical knowledge, or possible theoretical schemes, to distort their practical judgement, experience or reasoning. They must be considerate toward the auditee and refrain from making demands that will disrupt their employer's business.

6. **Professionalism.** Internal auditors should always adhere to their high professional calling and the ethical code that governs the profession, always acting sincerely, honestly and impartially.

7. **Independence and sound judgement.** Internal auditors must be completely independent, in mind as well as in their external relations with management and the auditee. This requires internal auditors to be free from control, and their professional judgement should not be subordinate to that of others.

8. **Integrity.** Integrity has to do with uprightness and honesty. Internal auditor's integrity should never be in doubt.

As students of internal auditing, make personal growth your goal, and strive to develop these characteristics.

Answer the questions below.

Question 1

Which one of the following alternatives is **not** one of the required personal characteristics of an internal auditor?

1. Pleasant personality.

2. Objectivity and confidence.

3. Extrovert personality.

4. Good human relations.

Question 2

Describe the formal requirements in South Africa that prospective internal auditors must meet before they can be awarded the professional Certified Internal Auditor (CIA) certificate.


Question 1

This question tested your knowledge of the required personal characteristics of an internal auditor. The personal characteristics required of an internal auditor are knowledge and competence, awareness of new developments, good human relations, diligence and patience, objectivity and confidence, practical approach, professionalism, independence and sound judgment, due professional care, integrity and pleasant personality. Option 3 is correct, as an extrovert personality is not a required characteristic of an internal auditor.

Question 2

Since the question specifies the formal qualifications for South Africa candidates, you must answer the requirements in the South African context.

1. Candidates should be in possession of a B Degree with Internal Auditing or equivalent qualification to enter the IAT program. Candidates must have obtained the IAT designation before entering the PIA program. It would also be advantageous to have exposure to Financial Accounting and Business Management.

2. Successfully completed and passed the IAT and PIA programs.

3. Successfully passed all three parts of the International CIA examination set by the International Institute of Internal Auditors.

4.   A good character, as attested to by a CIA or member through a character reference. This is one of the entrance requirements for the IAT program.
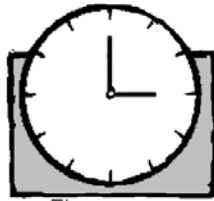
TOPIC SUMMARY

In this topic we discussed a very important element of professionalism, namely, the competencies expected of internal auditors. Due Professional Care and the personal characteristics which internal auditors need to exhibit were also discussed. It is important that these requirements should be formalised, because this is an important aspect on the road to professionalism. It is evident that the competencies required are both of a high level and unique. It is unfortunate that the stage has not yet been reached where only people with the above characteristics and qualifications are permitted to work as internal auditors. That would be a great advantage to the profession of internal auditing and the organisations it serves.

Now that you have worked through this topic, are you able to:

- describe the formal qualifications, knowledge, skills, competencies that an internal auditor should possess in order to carry out his professional duties?
- describe the personal characteristics that may be expected of an internal auditor?

TOPIC 5: THE PURPOSE, RESPONSIBILITIES AND LIABILITIES OF AN INTERNAL AUDITOR

INTRODUCTION AND PURPOSE OF THE TOPIC

The internal audit activity should have a charter, approved by executive management, which clarifies the purpose, authority and responsibility of the internal auditors.

This topic contains an account of the responsibilities of internal auditors towards the organisation they serve. We also discuss the internal auditor's responsibility with regard to fraud in more detail.

LEARNING OUTCOMES

When you have worked through this topic, you should be able to

- give an account of the internal auditing standards relating to the purpose, authority and responsibility of the internal auditor.
- apply your knowledge of the purpose, authority and responsibility of internal auditors in practical situations with reference to the charter of an internal audit activity.
- apply your knowledge of the responsibilities of the internal auditor with regard to fraud in practical situations.

CONTENT OF THE TOPIC

This topic is made up of the following learning units:

Learning unit	Title
5.1	The purpose, responsibilities and liabilities of an internal auditor
5.2	The internal auditor's role and responsibilities with regard to fraud

LEARNING UNIT 5.1: THE PURPOSE, RESPONSIBILITIES AND LIABILITIES OF AN INTERNAL AUDITOR

5.1.1 THE PURPOSE AND AUTHORITY OF AN INTERNAL AUDITOR

The internal audit activity in an organisation functions according to policies laid down by management and the board of directors. These policies vary from one organisation to another. The purpose, authority and responsibility of the internal audit activity should be defined in a formal, written document, referred to as a charter, which should be authorised by top management and accepted by the members of the board of directors.

The purpose, authority and responsibility of the internal audit activity, therefore, depend largely on the charter and the support it receives from management. Ideally, the internal auditor should be free to review and evaluate all the organisation's policy decisions, systems, procedures and records.

Regarding the internal audit charter, Standard 1000 states the following:

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 Definition of Internal Auditing, the Code of Ethics, and the Standards. The chief audit executive must periodically review the internal audit charter and present it to senior management and the board for approval.

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 organisation**, including the nature of the chief audit executive's functional reporting relationship with the board; **authorises 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.*

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

Practice Advisory 1000-1

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 organisation'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.

Here is an example of an internal audit department's charter, based on the one published on the IIA website:

Sample - Internal Audit Activity Charter

INTRODUCTION:

Internal Auditing is an independent and objective assurance and consulting activity that is guided by a philosophy of adding value to improve the operations of the <**organisation**>. It assists <**organisation**> in accomplishing its objectives by bringing a systematic and disciplined approach to evaluate and improve the effectiveness of the organisation's governance, risk management, internal control.

ROLE:

The internal audit activity is established by the Board of Directors, Audit Committee, or highest level of governing body (hereafter referred to as the Board). The internal audit activity's responsibilities are defined by the Board as part of their oversight role.

PROFESSIONALISM:

The internal audit activity will govern itself by adherence to The Institute of Internal Auditors' mandatory guidance including the Definition of Internal Auditing, the Code of Ethics, and the *International Standards for the Professional Practice of Internal Auditing* (*Standards*). This mandatory guidance constitutes principles of the fundamental requirements for the professional practice of internal auditing and for evaluating the effectiveness of the internal audit activity's performance.

The Institute of Internal Auditors' Practice Advisories, Practice Guides, and Position Papers will also be adhered to as applicable to guide operations. In addition, the internal audit activity will adhere to <**organisation**> relevant policies and procedures and the internal audit activity's standard operating procedures manual.

AUTHORITY:

The internal audit activity, with strict accountability for confidentiality and safeguarding records and information, is authorized full, free, and unrestricted access to any and all of <organisation> records, physical properties, and personnel pertinent to carrying out any engagement. All employees are requested to assist the internal audit activity in fulfilling its roles and responsibilities. The internal audit activity will also have free and unrestricted access to the Board.

ORGANISATION:

The Chief Audit Executive will report functionally to the Board and administratively (i.e. day to day operations) to the Chief Executive Officer.

The Board will

- Approve the internal audit charter.
- Approve the risk based internal audit plan.
- Approve the internal audit budget and resource plan.
- Receive communications from the Chief Audit Executive on the internal audit activity's performance relative to its plan and other matters.
- Approve decisions regarding the appointment and removal of the Chief Audit Executive.
- Approve the remuneration of the Chief Audit Executive.

- Make appropriate inquiries of management and the Chief Audit Executive to determine whether there is inappropriate scope or resource limitations.

The Chief Audit Executive will communicate and interact directly with the Board, including in executive sessions and between Board meetings as appropriate.

INDEPENDENCE AND OBJECTIVITY:

The internal audit activity will remain free from interference by any element in the organisation, including matters of audit selection, scope, procedures, frequency, timing, or report content to permit maintenance of a necessary independent and objective mental attitude.

Internal auditors will have no direct operational responsibility or authority over any of the activities audited. Accordingly, they will not implement internal controls, develop procedures, install systems, prepare records, or engage in any other activity that may impair internal auditor's judgment.

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

The Chief Audit Executive will confirm to the board, at least annually, the organisational independence of the internal audit activity.

RESPONSIBILITY:

The scope of internal auditing encompasses, but is not limited to, the examination and evaluation of the adequacy and effectiveness of the organisation's governance, risk management, and internal controls as well as the quality of performance in carrying out assigned responsibilities to achieve the organisation's stated goals and objectives. This includes:

- Evaluating risk exposure relating to achievement of the organisation's strategic objectives.
- Evaluating the reliability and integrity of information and the means used to identify, measure, classify, and report such information.
- Evaluating the systems established to ensure compliance with those policies, plans, procedures, laws, and regulations which could have a significant impact on the organisation.

- Evaluating the means of safeguarding assets and, as appropriate, verifying the existence of such assets.

- Evaluating the effectiveness and efficiency with which resources are employed.

- Evaluating operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned.

- Monitoring and evaluating governance processes.

- Monitoring and evaluating the effectiveness of the organisation's risk management processes.

- Evaluating the quality of performance of external auditors and the degree of coordination with internal audit.

- Performing consulting and advisory services related to governance, risk management and control as appropriate for the organisation.

- Reporting periodically on the internal audit activity's purpose, authority, responsibility, and performance relative to its plan.

- Reporting significant risk exposures and control issues, including fraud risks, governance issues, and other matters needed or requested by the Board.

- Evaluating specific operations at the request of the Board or management, as appropriate.

INTERNAL AUDIT PLAN:

At least annually, the Chief Audit Executive will submit to senior management and the Board an internal audit plan for review and approval. The internal audit plan will consist of a work schedule as well as budget and resource requirements for the next fiscal/calendar year. The Chief Audit Executive will communicate the impact of resource limitations and significant interim changes to senior management and the Board.

The internal audit plan will be developed based on a prioritization of the audit universe using a risk-based methodology, including input of senior management and the Board. The Chief Audit Executive will review and adjust the plan, as necessary, in response to changes in the organisation's business, risks, operations, programs, systems, and controls. Any significant deviation from the approved internal audit plan will be communicated to senior management and the Board through periodic activity reports.

REPORTING AND MONITORING:

A written report will be prepared and issued by the Chief Audit Executive or designee following the conclusion of each internal audit engagement and will be distributed as appropriate. Internal audit results will also be communicated to the Board.

The internal audit report may include management's response and corrective action taken or to be taken in regard to the specific findings and recommendations. Management's response, whether included within the original audit report or provided thereafter (i.e. within thirty days) by management of the audited area should include a timetable for anticipated completion of action to be taken and an explanation for any corrective action that will not be implemented.

The internal audit activity will be responsible for appropriate follow-up on engagement findings and recommendations. All significant findings will remain in an open issues file until cleared.

The Chief Audit Executive will periodically report to senior management and the Board on the internal audit activity's purpose, authority, and responsibility, as well as performance relative to its plan. Reporting will 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.

QUALITY ASSURANCE AND IMPROVEMENT PROGRAM:

The internal audit activity will maintain a quality assurance and improvement program that covers all aspects of the internal audit activity. The program will include 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.

The Chief Audit Executive will communicate to senior management and the Board on the internal audit activity's quality assurance and improvement program, including results of ongoing internal assessments and external assessments conducted at least every five years.

Internal Audit Activity charter

Approved this _____ day of _____, _____.

_____

Chief Audit Executive

_____

Chairman of the Board / Audit Committee

_____

Chief Executive Officer

Reference: The Institute of Internal Auditors' website at

 - https://na.theiia.org/standards-guidance

The purpose of the internal audit activity

The purpose of the internal audit activity should be derived from the definition of internal auditing (refer to learning unit 1.1). Internal auditors need to make a meaningful contribution to meet the needs of the organisation, which is mainly to achieve its objectives.

The following features need to be included in the internal audit charter to grant them the necessary authority:

- **Access to the books, records, vouchers and accounts**

  This authority is included because the internal auditor must have access to all the information pertaining to the audit assignment at all times. This includes the element of surprise visits and the associate access to evidence as irregularities may be discovered in this manner. In exercising his or her powers the internal auditor must, however, be reasonable in order to cause as little disruption to the normal operations of the organisation as possible. If his or her inquiry is of a serious nature, however, this fact should not deter him or her from demanding the necessary information even if this does upset the regular routine of the business.

- **Obtaining information and explanations**

  It is virtually impossible for an internal auditor to possess all the relevant knowledge required at all times. It is, therefore, necessary that management and staff should be

compelled to furnish the internal auditors with additional information and explanations should they require them.

This power to obtain information is very important, since by the very nature of their work the internal auditors will be compelled to ask for explanations for anything they do not understand or which may appear to be relevant or even suspicious. If the internal auditors are not satisfied with the explanations they receive, they should discretely mention this fact in their report after perusing all options to acquire the requested information. They should under no circumstances accept an explanation unless quite convinced of its correctness and, where possible, should always substantiate information received through explanations by auditees.

- **Attending meetings**

  Internal auditors need to keep abreast of matters concerning planning and policies within the organisation, so that they are able to perform their duties. It is, therefore, necessary for the internal auditor to attend and make a contribution to policy making meetings or to receive copies of the minutes of such meetings. Internal auditors should use their judgement on what information is really necessary to enable them to perform their duties.

- **Believing trusted officials**

  Internal auditors are entitled to place reliance on any information supplied to them by trusted employees in the organisation. If this was not the case, and if they had to establish the truth of every detail first, their task, especially in a very large undertaking, would be extremely difficult, if not almost impossible. Internal auditors must, however, exercise reasonable care, and treat each case on its merits, before they accept as trustworthy all information given to them by employees. Should they come across anything suspicious, they should, of course, spare no effort to get to the bottom of the matter or verify the information received.

  As a support function to the management team and in view of the nature of their duties, internal auditors should be involved (if only as observers) in all planning and policy-making decisions. They should, however, maintain their independence and objectivity by not taking decisions on management's behalf. In this way they will acquire the necessary background knowledge at first hand, and any queries they might have with regard to policies and important measures in the organisation will thus be eliminated. The internal auditing department should also be informed in writing of all important management

decisions on policies and procedures in the normal course of business. The risks associated with changes in policies and procedures could affect the annual audit plan and also the planning of individual audit engagements and the engagement objectives (refer to Topic 7).

- **Independence of the internal auditor**

  To prevent any possibility of his or her integrity, findings and recommendations being questioned, the internal auditor has to be independent of the staff and the operational activities on which he or she reports (refer to Standard 1000, The Internal Audit Charter).

  Organisational independence and objectivity are the primary means that internal auditors use to ensure their independence from the staff of the organisation and its normal business activities (refer to Standard 1100).

  The organisational independence and individual objectivity of internal auditors must be such that they always report to the highest authority. This is the only reliable way of ensuring that they remain independent and are respected throughout the hierarchy of the organisation. The audit committee plays an important role in making sure that the internal audit activity is independent.

- **Constraints on the internal auditor**

  Management can impose constraints on the internal auditor regarding access to records, explanations, independence, and so on. Unlike the external auditor, the internal auditor has no legal recourse in this regard. Therefore, where the internal auditor's powers are restricted by management, he or she should state in the report that certain constraints were imposed on the audit, and explain how these affected the findings. The auditor should, however, continue to try to persuade management not to impose unnecessary restrictions, as these prevent him or her from carrying out his or her duties as effectively as possible. In the ideal reporting framework, internal audit would also be in a position to report such constraints to the audit committee of the board of directors.

5.1.2 THE RESPONSIBILITY OF AN INTERNAL AUDITOR

The objective of internal auditing is to assist members of the organisation in the effective discharge of their responsibilities and to add value and improve the organisation's risk management, control and governance processes.

The internal auditor should use all the powers at his or her disposal and employ them in such a manner as to best execute his or her main task of assisting the members of the organisation. The duties of an internal auditor comprise more than mere review and reporting, and involve certain responsibilities:

Responsibility to management

As a consequence of their basic function, namely, to assist the management of the organisation in carrying out their responsibilities, internal auditors have special duties towards management.

Since internal auditors cooperate so closely with management in fulfilling the important role of evaluating management's activities, they need to maintain good relations with management, without compromising their objectivity in any way. This task could become difficult when the internal auditor needs to be critical of management's activities. Internal auditors must have a very clear picture of management's style, strategy, vision and mission, general approach and attitudes, priorities, and so on.

It is their duty to examine every management function objectively and report on it timeously.

 Refer to Standard 1110 regarding organisational independence.

Responsibility regarding the execution of tasks

In addition to the above responsibility to management, internal auditors also have responsibilities in respect of the execution of their tasks.

In the execution of these responsibilities internal auditors are required to perform such tests, procedures or audit investigations that will provide adequate information to enable them to form a definite audit opinion on the specific audit, which must be included in the internal audit report.

The internal auditor has an obligation to carry out his or her task in accordance with the guidelines contained in the Internal Auditing Standards and the Code of Ethics (see learning units 3.2 and 3.3).

Responsibility toward employer

In consequence of their contractual obligation as employees, internal auditors have an obligation toward their employer to act in good faith in the fulfilment of their duties.

The following aspects are usually included in this contractual obligation: Internal auditors –

1. may not use confidential information obtained in the performance of their duties for their own gain, or impart such knowledge to third parties.

2. should further the interests of their employer's business undertaking.

3. may not perform acts of dishonesty (fraud, theft) against their employer.

4. may not perform acts which are in competition with their employer.

5. may not perform acts of misconduct while performing their duties.

5.1.3 THE LIABILITIES OF AN INTERNAL AUDITOR

In South Africa, the liability of internal auditors derives mainly from legal system principles.

Liability towards the employer

Internal auditors are responsible for fulfilling their duties as contracted with their employer. They should perform these duties in a capable manner and without negligence. The auditor is guilty of breach of contract if he or she contravenes the stipulations of the contract of service, or should he or she be found to be incompetent or negligent.

In the case of breach of contract, the employer has the following legal remedies:

1. In terms of the general principles of the law of contract, appeal to the court to issue an order forcing the internal auditor to abide by the stipulations of the contract.

2. Claim compensation for all losses sustained from the breach of contract by the internal auditor.

3. When the breach of contract is considered to be very serious, summarily terminate the internal auditor's contract of service.

Liability towards third parties

The liability of internal auditors toward third parties for wrongful acts, originates from negligent or deliberate misrepresentation by them in the performance of their duties.

There is no contractual relationship, nor any relationship of confidence between the internal auditor and third parties. Because the internal auditor does not report on the fairness of the financial statements of the undertaking, no liability can originate via the financial statements. For liability to ensue, the internal auditors must have been aware that third parties were going to rely on their recommendations.

Presumably third parties will hold the undertaking responsible for an act of negligence committed by the internal auditors in the performance of their duties. In this case the undertaking should be able to institute legal action against the internal auditor.

A third party, however, has a definite claim for compensation from the internal auditor personally if the internal auditor is found to be guilty of deliberate misrepresentation. In this case the third party could even hold the undertaking and the internal auditor jointly and separately responsible.

In the case of wrongful acts through negligence or deliberate misrepresentation by the internal auditor, the onus of proof rests with the third party.

The third party will have to prove that –

1. there was misrepresentation (an act)

2. the internal auditors were negligent in the performance of their duties, that is, that the misrepresentation was wilful or negligent (guilt desideratum)

3. the loss sustained by the third party resulted from his or her dependence on the misrepresentation (causality)

4. the third party sustained a monetary loss as a result of the misrepresentation (damage)

5. the internal auditors were aware of the dependence of the third party when they committed the misrepresentation (wrongful desideratum).

LEARNING UNIT 5.2: THE INTERNAL AUDITOR'S ROLE AND RESPONSIBILITIES WITH REGARD TO FRAUD

INTRODUCTION

When executing their duties, internal auditors should apply the care and skill expected of a prudent and competent internal auditor in the same or similar circumstances. Due professional care is, therefore, appropriate to the complexities of the audit being performed. In exercising due professional care, internal auditors should be alert to the probability of intentional wrongdoing, irregularities, errors and omissions, inefficiency, waste, ineffectiveness and conflicts of interest. They should also be on the lookout for these wherever irregularities are most likely to occur.

Fraud is just one of the risks to which organisations are exposed, and this is of particular concern today. The management of any organisation must take cognisance of fraud, and any controls introduced should be consciously aimed at preventing or detecting it. This learning unit deals with the nature of fraud and the role and responsibilities of internal audit in detecting and preventing it.

The *IPPF – Practice Guide on Internal Auditing and Fraud* states:

Fraud negatively impacts organisations in many ways including financial, reputation, psychological and social implications. According to various surveys, monetary losses from fraud are significant. However, the full cost of fraud is immeasurable in terms of time, productivity, and reputation including customer relationships. Depending on the severity of the loss, organisations can be irreparably harmed due to the financial impact of fraud activity. Therefore, it is important for organisations to have a strong fraud program that includes awareness, prevention, and detection programs, as well as a fraud risk assessment process to identify fraud risks within the organisation.

5.2.1 Nature and categories of fraud

What is fraud?

In the glossary of the Standards **fraud** is defined as follows:

Any illegal acts characterised by deceit, concealment, or violation of trust. These acts are not dependent upon the application of threats of violence or physical force. Fraud is perpetrated by individuals and organisations to obtain money, property, or service; to avoid payment or loss of services; or secure personal or business advantages.

The *IPPF – Practice Guide on Internal Auditing and Fraud* gives further guidance on fraud:

Fraud can be committed by an employee at any level **within** an organisation, as well as by anyone **outside** the organisation.

There are three **common characteristics** of fraud:

- **Pressure or incentive** - the need the fraudster is trying to satisfy by committing the fraud.
- **Opportunity** - the fraudster's ability to commit the fraud.
- **Rationalisation** - the fraudster's ability to justify the fraud in his or her mind.

Examples of fraud

A person commits fraud knowing that it could result in some unauthorised benefit to him or her, to the organisation, or to another person. Fraud can be perpetrated by persons either outside or inside the organisation. Some common fraud schemes are:

- o **Asset misappropriation.** This involves stealing cash or assets (supplies, inventory, equipment, and information) from the organisation.
- o **Skimming.** This involves stealing cash from an organisation before it is recorded on the organisation's books and records. For example, an employee accepts payment from a customer, but does not record the sale.
- o **Disbursement fraud.** This occurs when a person causes the organisation to issue a payment for fictitious goods or services, inflated invoices, or invoices for personal purchases. For example, an employee can create a shell company and then bill the employer for non-existent services. Other examples are fraudulent health care claims (billings for services not rendered, unbundled billings instead of bundled billings),

unemployment insurance claims by people who are in fact working, or pension or social security claims for people who have died.

o **Expense reimbursement fraud**. This involves an employee being paid for fictitious or inflated expenses. For example, an employee submits a fraudulent expense report claiming reimbursement for personal travel, non-existent meals, extra mileage, and so on.

o **Payroll fraud**. This occurs when the fraudster causes the organisation to issue a payment by making false claims for compensation. For example, an employee claims overtime for hours not worked or an employee adds ghost employees to the payroll and receives the paycheque.

o **Financial statement fraud**. This involves misrepresenting the financial statements, often by overstating assets or revenue or understating liabilities and expenses. Financial statement fraud is typically perpetrated by organisation managers who want to enhance the economic appearance of the organisation. Members of management may benefit directly from the fraud by selling stock, receiving performance bonuses, or using the false report to conceal another fraud.

o **Information misrepresentation**. This involves providing false information, usually to those outside the organisation. It usually involves fraudulent financial statements, although falsification of information used as performance measures can also occur.

o **Corruption**. This is the misuse of entrusted power for private gain. Corruption includes bribery and other improper uses of power. Corruption is often an off-book fraud; by this we mean that there is little financial statement evidence available to prove that the crime occurred. Corrupt employees do not have to fraudulently change financial statements to cover up their crimes – they simply receive cash payments under the table.

o **Bribery**. This is the offering, giving, receiving, or soliciting of anything of value to influence an outcome. Bribes may be offered to key employees or managers such as purchasing agents who have discretion in awarding business to vendors. Typically, a purchasing agent accepts kickbacks to favour an outside vendor in buying goods or services. The flip side of offering or receiving anything of value is demanding it as a condition of awarding business: this is termed economic extortion. Another example is a corrupt lending officer who demands a kickback in exchange for approving a loan. Those paying bribes tend to be commissioned salespeople or intermediaries for outside vendors.

o **Conflict of interest**. This occurs where an employee, manager, or executive of an organisation has an undisclosed personal economic interest in a transaction that adversely affects the organisation or the shareholders' interests.

o **Diversion**. This involves diverting a potentially profitable transaction to an employee or outsider that would normally generate profits for the organisation.

Fraud prevention and detection

Fraud prevention entails implementing policies and procedures, employee training, and management communication to educate employees about fraudulent activities. It also entails activities and programs designed to identify fraud or misconduct that is occurring or has occurred.

Typical roles/responsibilities relating to fraud prevention and detection

1. Board of directors

   The board of directors is responsible for effective and responsible corporate fraud governance. The role of the board is to oversee and monitor management's actions to manage fraud risks. It is also responsible for setting the tone for fraud risk management within an organisation.

2. Audit committees

   An audit committee of the board of directors is the independent eyes and ears of the investors and other stakeholders.

   The committee's responsibilities are to:

   o To evaluate management's identification of fraud risks and the implementation of anti-fraud measures, and to provide the tone at the top that fraud will not be accepted in any form.
   o To oversee controls to prevent or detect management fraud.
   o To oversee senior management's compliance with appropriate financial reporting and for preventing senior management override of controls or other inappropriate influence over the reporting process.

3. Management

   Management is responsible for fraud prevention, their responsibilities include:

   o implementing and monitoring processes and internal controls.

o establishing and maintaining an effective internal control system at a reasonable cost.

4. Internal auditors

Internal auditors evaluate risks faced by their organisations based on audit plans with appropriate testing. Internal auditors need to be alert to the signs and possibilities of fraud within an organisation. Specifically, internal auditors can assist in deterring fraud by examining and evaluating the adequacy and effectiveness of internal controls.In addition, they may assist management in establishing effective fraud prevention measures by knowing the organisation's strengths and weaknesses and providing consulting expertise.

5.2.2 Internal auditor's roles and responsibilities with regard to fraud

The following Internal Auditing Standard forms the basis for the internal auditor's role with regard to fraud:

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

There are references to the responsibility of internal audit regarding fraud in various Internal Auditing Standards. In this regard, the following Standards are also of particular importance:

- IIA Standard 1200:   Proficiency and Due Professional Care
- IIA Standard 1220:   Due Professional Care
- IIA Standard 2060:   Reporting to Senior Management and the Board
- IIA Standard 2120:   Risk Management
- IIA Standard 2210:   Engagement Objectives

In conducting audit engagements, the internal auditor should:

o Consider fraud risks in the assessment of internal control design and determination of audit steps to perform. Internal auditors are not expected to detect fraud, but internal auditors are expected to obtain reasonable assurance that business objectives for the process under review are being achieved and material control deficiencies — whether through simple error or intentional effort — are detected. The consideration of fraud risks

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is documented in the working papers, as well as linkage of fraud risks to specific audit work.

o Have sufficient knowledge of fraud to identify red flags indicating fraud may have been committed. This knowledge includes the characteristics of fraud, the techniques used to commit fraud, and the various fraud schemes and scenarios associated with the activities reviewed.

o Be alert to opportunities that could allow fraud, such as control deficiencies. If significant control deficiencies are detected, additional tests conducted by internal auditors could be used to identify whether fraud has occurred.

o Evaluate whether management is actively retaining responsibility for oversight of the fraud risk management program, that timely and sufficient corrective measures have been taken with respect to any noted control deficiencies or weaknesses, and that the plan for monitoring the program continues to be adequate for the program's ongoing success.

o Evaluate the indicators of fraud and decide whether any further action is necessary or whether an investigation should be recommended.

o Recommend investigation when appropriate.

The internal auditor's role in fraud investigations

The role of the internal audit activity in investigations needs to be defined in the internal audit charter, as well as in the fraud policies and procedures. For example, internal auditing may have the primary responsibility for fraud investigations, may act as a resource for investigations, or may refrain from involvement in investigations. Internal auditing may refrain from involvement because it is responsible for assessing the effectiveness of investigations or because it lacks the appropriate resources to be involved in investigations. Any of these is acceptable, as long as the impact of these activities on the independence of internal auditing is recognised and handled appropriately.

In addition to advising management, internal auditors may become involved in investigations by:

• monitoring the investigation process to help the organisation follow relevant policies, procedures, and applicable laws and statutes (where internal auditing was not responsible for conducting the investigation).

• locating and/or securing the misappropriated or related assets.

• supporting the organisation's legal proceedings, insurance claims, or other recovery actions.

- evaluating and monitoring the organisation's internal and external post-investigation reporting and communication plans and practices.
- monitoring the implementation of recommended control enhancement.

Internal auditors typically assess the facts of investigations and advise management relating to remediation of control weaknesses that lead to the fraud. Internal auditors may design steps in audit programmes or develop "auditing for fraud" programmes to help disclose the existence of similar instances of fraud in the future.

Reporting fraud investigations

Reporting fraud investigations consists of the various oral, written, interim, or final communications to senior management and/or the board regarding the status and results of fraud investigations. Reports can be preliminary and ongoing throughout the investigation. If internal auditing conducts the investigation, IIA Standard 2400: Communicating Results provides information applicable to necessary engagement communications.
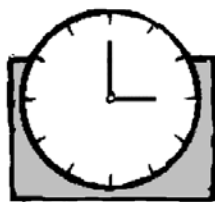
TOPIC SUMMARY

Some very important aspects of the working environment of the internal auditor were explained in this topic. It is important that the purpose, authority and responsibilities of the internal auditor should be very clearly spelled out. It is self-evident that the internal auditor must be fully aware of these aspects of his or her duties.

We also covered the internal auditor's responsibility with regard to fraud in organisations. This topic gives a detailed explanation of the nature of fraud as well as an introduction to the prevention and detection of fraud. Internal auditors need a proper knowledge and understanding of their responsibility with regard to fraud in organisations.

Now that you have worked through this topic, are you able to:

- give an account of the internal auditing standards requirements relating to the purpose, authority and responsibility of internal auditors?
- apply your knowledge of the responsibilities and liabilities of an internal auditor in practical situations.
- describe the internal auditor's role in the regarding fraud?

PART D: CONDUCTING AN INTERNAL AUDIT ENGAGEMENT

TOPIC 6: CONCEPTS RELATING TO INTERNAL AUDIT

INTRODUCTION AND PURPOSE OF THE TOPIC

This topic contains an overview of the important concepts of governance, risk management and control and how the internal audit activity should plan and conduct its services to achieve the aim of improving governance, risk management and control in organisations.

 LEARNING OUTCOMES

When you have worked through this topic, you should be able to

- explain the concepts of risk management, control and governance.

CONTENT OF THE TOPIC

This topic is made up of the following learning unit:

Learning unit	Title
6.1	Governance, risk management and control

LEARNING UNIT 6.1: GOVERNANCE, RISK MANAGEMENT AND CONTROL

6.1.1 INTRODUCTION

The definition of internal auditing (as discussed in Topic 1) states very clearly that the internal audit activity contributes to the improvement of governance, risk management and control processes within organisations. This aligns internal auditing with the current trends in corporate governance codes and best practice guidelines internationally.

IIA Standards 2100 – Nature of Work states that the internal audit activity must evaluate and contribute to the improvement of governance, risk management, and control processes using a systematic and disciplined approach.

In essence, if the organisation manages and applies good corporate governance principles, these generally also filter through to the risk management and control processes. It is important that the internal audit activity evaluate these processes in the sequence suggested above in order to conduct efficient and effective internal audits.

6.1.2   GOVERNANCE PROCESS

What is governance?

Governance is the process put in place by an organisation's top management to manage the organisation in the pursuit of its goals. Through governance, the needs of all the stakeholders involved with that specific organisation should be balanced.

According to the IIA Glossary, governance means the *combination of processes and structures implemented by the board to inform, direct, manage, and monitor the activities of the organisation toward the achievement of its objectives.*

Corporate governance

Corporate governance represents a collection of broad principles and practices for the efficient, effective and profitable running of an organisation in pursuit of its objectives. It should comply with principles of best practice and applicable legal and regulatory requirements in this process.

In other words, governance is the process that the top management of an organisation has put in place to manage the organisation in the pursuit of its goals.

Sir Adrian Cadbury is known as a pioneer in raising awareness and stimulating debate on corporate governance, and his name is associated with the Cadbury Code, a code of best practice that served as a basis for the reform of corporate governance around the world. Sir Adrian Cadbury defined corporate governance as follows:

Corporate governance is concerned with holding the balance between individual and communal goals. The aim is to align as nearly as possible the interests of individuals, corporations and society.

The disastrous effect of the absence of good corporate governance in organisations was seen in the collapse in the early years of this century of large companies such as Enron and WorldCom that occurred in 2002 in the USA. Enron was a major American energy company, which reported extremely good financial results and attracted investors. There was no indication of the serious trouble the company was in until it suddenly and unexpectedly collapsed. Its reported financial condition was sustained largely by institutionalised, systematic and creatively planned accounting fraud. From 1999 until May 2002 another company, WorldCom, used fraudulent accounting methods to mask its declining earnings by painting a false picture of financial growth and profitability to prop up the price of its shares. These are just two of many similar examples of organisations that misled stakeholders. Good corporate governance aims to prevent cases like these by laying down principles for the effective management of organisations.

The 1994 King Report on Corporate Governance in South Africa successfully formalised the need for organisations to recognise that they can no longer act independently from the societies and the environments in which they operate. An updated report, known as the King II Report, was issued in March 2002, and the latest version, the King III Report, was released in September 2009 and came into effect on 01 March 2010.

King III applies to all forms of organisations and is based on the "apply or explain" principle. Directors are required to **"apply or explain"** the reasons for not doing so. King III, applies to "all entities regardless of the manner and form of incorporation or establishment and whether in the public, private or non-profit sectors". All companies are encouraged to follow the Code, but are not required by law to do so and they could follow the "apply or explain" approach to its principles and recommended practices. The principles in King III are drafted on the basis that, if they are adhered to, any entity would have practised good governance, and the benefits of following the Code are numerous.

The King III revolves around leadership, sustainability and corporate citizenship. The King III report highlights these following key aspects:

1. Good governance is essentially about **effective leadership**. Leaders should rise to the challenges of modern governance. Such leadership is characterised by the ethical values of responsibility, accountability, fairness and transparency and based on moral duties that find expression in the concept of Ubuntu. Responsible leaders direct company strategies and operations with a view to achieving sustainable economic, social and environmental performance.

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2. **Sustainability** is the primary moral and economic imperative of the 21st century. It is one of the most important sources of both opportunities and risks for businesses. Nature, society, and business are interconnected in complex ways that should be understood by decision-makers. Most importantly, current incremental changes towards sustainability are not sufficient – we need a fundamental shift in the way companies and directors act and organise themselves.

3. The concept of **corporate citizenship** which flows from the fact that the company is a person and should operate in a sustainable manner. Sustainability considerations are rooted in the South African Constitution which is the basic social contract that South Africans have entered into. The Constitution imposes responsibilities upon individuals and juristic persons for the realisation of the most fundamental rights.

The internal auditor's responsibility toward governance

The definition of internal auditing requires internal auditors to evaluate the effectiveness of the governance process. To do this, the internal auditor should know enough about governance to be able to compare current practice with other best practices, and should be familiar with the organisation, its financial, ethical and social systems, and the environment in which it operates. This knowledge and understanding will enable the internal auditor to contribute successfully to governance by improving and adding value to the existing systems. Internal auditors should be guided by the King Report on Corporate Governance for South Africa (King III) during their evaluation process, as reflected by IIA Standard 2110.

IIA Standard 2110 - Governance

The internal audit activity must **assess and make appropriate recommendations** for improving the governance process in its accomplishment of the following objectives:
- Promoting appropriate ethics and values within the organisation;

- Ensuring effective organisational performance management and accountability;

- Communicating risk and control information to appropriate areas of the organisation; and

- Coordinating the activities of and communicating information among the board, external and internal auditors, and management.

2110.A1 – The internal audit activity must **evaluate** the design, implementation, and effectiveness of the organisation's ethics-related objectives, programs, and activities.
2110.A2 – The internal audit activity must **assess** whether the information technology governance of the organisation supports the organisation's strategies and objectives.

In short, the scope of internal auditing should, therefore, provide reasonable assurance that management's governance processes are effective in achieving the organisational objectives.

6.1.3 RISK MANAGEMENT PROCESS

What is risk?

According to the International Standards for the Professional Practice of Internal Auditing, **risk** is defined as *the uncertainty of an event occurring that could have an impact on the achievement of objectives. Risk is measured in terms of consequences and likelihood*.

This relates to all objectives – strategic, financial, control and compliance objectives. It can be either positive or negative.

What is business risk?

Business risk is defined as *the threat that an event or action will adversely affect an organisation's ability to achieve its business objectives and execute its strategies successfully*. Business risk is comprised of strategic risk, financial risk, operational and sustainability risk.

So what is risk management?

According to the IIA Glossary, **risk management** is *a process to identify, assess, manage, and control potential events or situations to provide reasonable assurance regarding the achievement of the organisation's objectives*.

Therefore, risk management is the management process used in any organisation to manage the risks that impact on the achievement of the organisation's objectives. The risk management process entails the planning, arranging and controlling of activities and resources to minimise the impacts of all risks to levels that can be tolerated by shareholders whom the board has identified as relevant to the business of the company.

Risk management is defined in the **King III Report** as follows:

Risk management is the identification and evaluation of actual and potential risk areas as they pertain to the company as a total entity, followed by a process of either avoidance, termination, transfer, tolerance (acceptance), exploitation, or mitigation (treatment) of each risk, or a response that is a combination or integration.

The internal auditor's responsibility toward risk management

Management is accountable to the board for designing, implementing and monitoring the process of risk management, and for integrating it into the day-to-day activities of the company. The internal audit activity should assist the board, directors and management through consultation and facilitation in identifying, evaluating and assessing significant risks and by providing independent assurance as to the adequacy and effectiveness of related internal controls and the risk management process as indicated by the following Standard.

Standard 2120 – Risk Management

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

Interpretation:
Determining whether risk management processes are effective is a judgment resulting from the internal auditor's assessment that:
- Organisational objectives support and align with the organisation's mission;
- Significant risks are identified and assessed;
- Appropriate risk responses are selected that align risks with the organisation's risk appetite; and
- Relevant risk information is captured and communicated in a timely manner across the organisation, enabling staff, management, and the board to carry out their responsibilities.

The internal audit activity may gather the information to support this assessment during multiple engagements. The results of these engagements, when viewed together, provide an understanding of the organisation's risk management processes and their effectiveness. Risk management processes are monitored through ongoing management activities, separate evaluations, or both.

> **2120.A1 –** The internal audit activity must evaluate risk exposures relating to the organisation's governance, operations, and information systems regarding the:
> - Achievement of the organisation's strategic objectives;
> - Reliability and integrity of financial and operational information;
> - Effectiveness and efficiency of operations and programs;

- Safeguarding of assets; and

- Compliance with laws, regulations, policies, procedures, and contracts.

2120.A2 – The internal audit activity must evaluate the potential for the occurrence of fraud and how the organisation manages fraud risk.

2120.C1 – During consulting engagements, internal auditors must address risk consistent with the engagement's objectives and be alert to the existence of other significant risks.

2120.C2 – Internal auditors must incorporate knowledge of risks gained from consulting engagements into their evaluation of the organisation's risk management processes.

2120.C3 – When assisting management in establishing or improving risk management processes, internal auditors must refrain from assuming any management responsibility by actually managing risks.

The most difficult part of any risk management process is to identify all the risks for an organisation. Thus, during the evaluation process, the definition of internal auditing requires the internal auditor to adopt a systematic, disciplined approach. The most critical of the internal auditor's tasks is to ensure that all the relevant risks were in fact identified by means of the risk management process.

The evaluation of the risk management process by the internal auditor will give management assurance regarding the success achieved in the risk management process and in the achievement of its goals. In this way the internal auditor will add value to the organisation as a whole and facilitate the process of continuous improvement **by highlighting any deviations from, or shortcomings in the risk management process**, and **recommending improvements** to the process where appropriate.

In any organisation the extensive number of risks is overwhelming. Therefore there was a great need for a process to effectively understand and manage risks across the organisation. This was achieved by the introduction of enterprise risk management (ERM).

Enterprise risk management (ERM) is the identification and management of risks in the face of uncertainty as an integral part of value creation and preservation for the organisation, in a manner that will provide reasonable assurance of the achievement of the organisation's objectives.
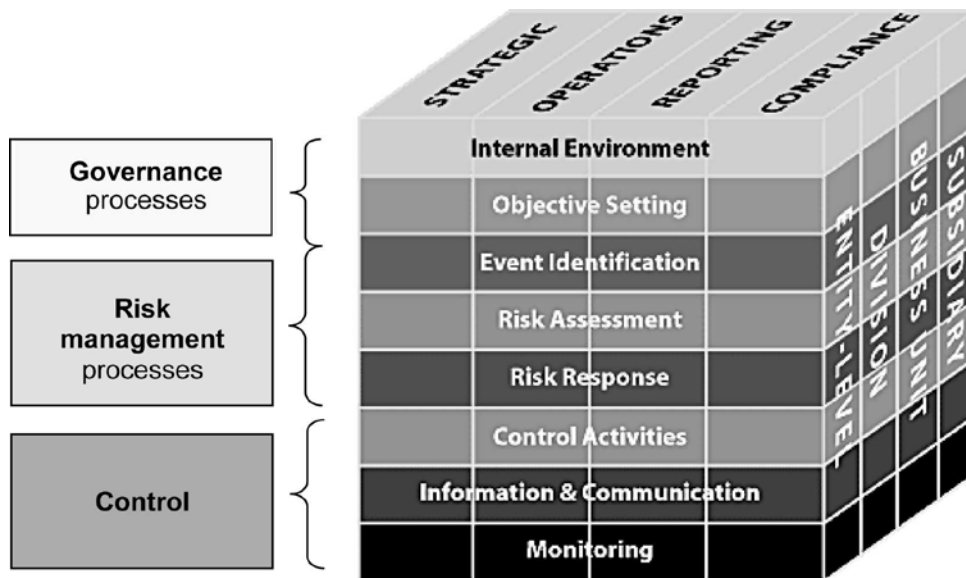
Figure 6.1: Enterprise risk management

(Source: ERM Framework)

An important aspect of the risk management process is a system of internal control that reduces risks to a level that the board considers acceptable - this is the "risk appetite" of the organisation.

Standard 1220.A3 states that internal auditors must be alert to the significant risks that might affect objectives, operations, or resources. However, assurance procedures alone, even when performed with due professional care, do not guarantee that all significant risks will be identified.

Nature of work

The work performed by the internal audit activity should be of such a nature that it enables the auditors to evaluate and contribute to the improvement of governance, risk management and control systems or processes. The internal audit activity should start by:

1) Finding out exactly what the **objectives of the organisation** are and evaluate the governance processes.

2) Then it **reviews the risk management process**.

3) After evaluating the risk management process, internal audit can **evaluate the control processes**.

The sequence in which this is done is very important, because the control process is based on the risk management process. Only after the internal auditors are certain that the governance

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processes are well managed can they look at risk management and control. In essence, if the organisation manages and applies good corporate governance principles, it generally tends to manage the risk management and control processes well.

Proper control starts with identifying the organisational objectives, as this is the basis of what everyone in the organisation should work to achieve.

What are organisational objectives?

Every organisation must establish objectives that will determine the purpose of that organisation's activities; this starts with establishing the vision and mission statements for the organisation. Organisational objectives can be described as the ideals or goals that an organisation is aspiring toward.

The mission statement defines the purpose of the organisation; what the organisation does.

The mission is broken down into organisational objectives for each business unit or process. The setting of these objectives could range from a formal, structured process to an informal process.

Organisational objectives can be:

- **Strategic objectives** – pertain to the value creation choices management makes on behalf of the organisation

- **Operations objectives** – pertain to the effectiveness and efficiency of the organisation's operations, including performance and profitability goals and safeguarding resources against losses

- **Reporting objectives** – pertain to the reliability of internal and external reporting of financial and operational information

- **Compliance objectives** – pertain to adherence to applicable laws and regulations

The executive management uses these objectives to identify the risks that have an impact on the organisation and develops controls to address these risks to ensure that the organisational objectives will actually be achieved. Management, therefore, puts assets at risk to achieve objectives. Assets are exposed to risks such as damage, unauthorised usage or abuse, theft and fire, and other natural disasters.

What are business processes?

A business process is a unit of work executed within the business to meet the needs or objectives of a business or organisation. The mix and structure of the processes will be unique for each organisation. If the internal auditor is to add value and improve an organisation's operations, he or she needs to understand the organisation's business processes. Organisations divide activities into business processes and projects to achieve their objectives.

Effective managers should then identify the risks that could impact on these objectives by carrying out a **risk assessment**, and develop successful strategies on how they would manage the risks. The risk management process, therefore, consists of the controls management implements to control or mitigate the risks identified. In this process the internal auditor assists them by giving them assurance on whether or not all the important risks have been identified and whether they are properly controlled.

Risk assessment is described in COSO Internal Control - Integrated Framework 2013), as follows: *Risk assessment involves a dynamic and iterative process for identifying and assessing risks to the achievement of objectives. Thus, risk assessment forms the basis for determining how risks will be managed.*

Risk assessment can be done by using questionnaires, interviews (individual) and workshops (control self-assessment or CSA). Most internal audit activities have limited resources. It, therefore, makes sense to apply most of these resources to those areas where the risk of errors and fraud is the greatest.

6.1.4 CONTROL PROCESS

What is control?

The IIA defines **control** as follows:

Any action taken by management, the board, and other parties to manage risk and increase the likelihood that established objectives and goals will be achieved. Management plans, organizes, and directs the performance of sufficient actions to provide reasonable assurance that objectives and goals will be achieved.

The IIA defines **control processes** as follows:

The policies, procedures (both manual and automated), and activities that are part of a control framework, designed and operated to ensure that risks are contained within the level that an organisation is willing to accept.

Controls should be established to encompass all management responses to risk. Controls are derived from the way management runs the company, and should be integrated into all business processes at every level of the company.

Controls may be

i.   preventive (to deter undesirable events)
                or

ii.   detective (to detect and correct undesirable events which have occurred)
                or

iii.   directive (to bring about or encourage a desirable event).

The following are examples of controls (a control) and their (its) classification:

Table 6.1: Controls

Preventive controls	Detective controls	Directive controls
Personnel access cards	Reconciliations to be done	Procedure manuals
Cabinets/locks/keys	Control accounts to be balanced	Company policy
Security areas/ cameras	Circular letters	Prescribed standards
Internal audit report	Exception reports	Certain meetings
Use of carbon paper	Physical stock count	Insurance
Ethical "tone at the top"	Alarms	Guidelines
	Smoke detectors	Training programmes

All variants of the term control (administrative control, internal accounting control, internal control, management control, operational control, output control, preventive control, etc.) can

be incorporated within the generic term. These variants differ primarily in terms of the objectives to be achieved. Since these variants are useful in describing specific control applications, participants in the control process should be familiar with the terms as well as their applications. However, the methodology followed by internal auditing in evaluating these controls is consistent for all of the variants.

What is internal control?

You need to understand the generic meaning of "control'" before you study the concept "internal control", otherwise you may find it difficult to understand the distinction between them.

Internal control is an offshoot of "control" and it represents, broadly speaking, the entire set of control measures (internal control system), that are put into operation to give effect to "control" in the broad sense.

Internal control, which is usually embodied in a system of control measures, and should, therefore, be seen as the same concept, is a comprehensive concept and cannot be reflected in a brief definition. In view of the large number of elements that make up this concept, comprehensive descriptions and further explanations are required to analyse and explain it.

A good guide on the internal control process is the publication, Internal Control -Integrated Framework, which was published in 1994 and was developed by the Committee of Sponsoring Organisations of the Treadway Commission, or the COSO framework, as it is more commonly referred to. An update to the framework was released in May 2013. The Enterprise-wide Risk Management (ERM) framework, also published by COSO, supplements the internal control framework.

In COSO Internal Control — Integrated Framework 2013, internal control is broadly defined as follows:
Internal control is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting, and compliance.

The following is a definition of a system of internal control from a study (the SAC study) by the Institute of Internal Auditors of the USA. It is important that you pay attention to every phrase of the definition, because every phrase is significant for the purposes of perspective and understanding. Pay attention to the relationship between this definition and the definition of

"control". This definition embraces all the activities of an organisation (Sawyer & Dittenhofer 2003:p69-70):

The study defined an organisation's system of internal control as follows:

The means established to provide reasonable assurance that the overall objectives and goals of the organisation are achieved in an efficient, effective, and economical manner ... a set of processes, functions, activities, subsystems, and people who are grouped together or consciously segregated to ensure the effective achievement of objectives and goals.

Traditionally, auditors have used a series of internal control functions to determine if an organisation's controls function adequately. As times changed, questions were asked as to whether this was still a suitable way to evaluate the company's control functions. How control and governance integrate in a control environment is an important part of every internal audit. A new look was taken to determine how control should be looked at, which resulted in the establishment of the following three control models:

- COSO framework (by the Committee of Supporting Organisations of the Treadway Commission)
- CoCo framework (The Criteria of Control Board of the Canadian Institute of Chartered Accountants)
- Cadbury Report (The Financial Aspects of Corporate Governance)

We only refer to the COSO model in this module.

You can see the five interrelated components of the COSO internal control model in the figure below.

Figure 6.2: The COSO integrated control framework (COSO 2013)

According to the COSO model, internal control consists of the following five interrelated components:

1. **Control Environment**

   The control environment is the set of standards, processes, and structures that provide the basis for carrying out internal control across the organisation. The board of directors and senior management establish the tone at the top regarding the importance of internal control including expected standards of conduct. It includes factors such as integrity and ethical values, the organisational structure and assignment of authority and responsibility; competence; and the rigour around performance measures, incentives, and rewards to drive accountability for performance.

2. **Risk Assessment**

   Risk assessment involves a dynamic and iterative process for identifying and assessing risks to the achievement of objectives. Risk assessment forms the basis for determining how risks will be managed.

   Assesses risks from two perspectives:

   - Likelihood
   - Impact

3. **Control Activities**

Control activities are the actions established through policies and procedures that help ensure that management's directives to mitigate risks to the achievement of objectives are carried out. Control activities are performed at all levels of the entity, at various stages within business processes, and over the technology environment.

4. **Information and Communication**

Management obtains or generates and uses relevant and quality information from both internal and external sources (flowing down, across and up through all levels of the organisation) to support the functioning of other components of internal control. Communication is the continual, iterative process of providing, sharing, and obtaining necessary information.

5. **Monitoring Activities**

Ongoing evaluations, separate evaluations, or some combination of the two are used to ascertain whether each of the five components of internal control, including controls to effect the principles within each component, is present and functioning.

The role of the internal audit activity in terms of control

The internal audit activity's role with regard to control, is to assist the directors and management in maintaining effective controls by evaluating those controls to determine their efficiency and effectiveness, and by developing recommendations for enhancement or improvements. The following standard explains the role of the internal audit activity in terms of control.

Standard 2130 – Control

The internal audit activity must assist the organisation in maintaining effective controls by evaluating their effectiveness and efficiency and by promoting continuous improvement.

2130.A1 – The internal audit activity must evaluate the adequacy and effectiveness of controls in responding to risks within the organisation's governance, operations, and information systems regarding the:

- Achievement of the organisation's strategic objectives;

- Reliability and integrity of financial and operational information;

- Effectiveness and efficiency of operations and programs;

- Safeguarding of assets; and

- Compliance with laws, regulations, policies, procedures, and contracts.

2130.C1 – Internal auditors must incorporate knowledge of controls gained from consulting engagements into evaluation of the organisation's control processes.

What is Control Self-assessment?

Sawyer (2003:p424) defines **Control Self-assessment** as follows: *A process whereby employee teams and management, at local and at executive levels continuously maintain awareness of all material factors affecting the likelihood of achieving the organisation's objectives, thereby enabling them to make appropriate adjustments.*

It is further stated that to promote independence, objectivity, and quality within the process, as well as effective governance, it is a good idea to involve internal auditors in the process and that they independently report to senior management and board committees.

Managers and internal auditors can use the control self-assessment methodology to **assess the adequacy of the organisation's risk management and control processes**. Internal auditors can utilise control self-assessment programmes for gathering relevant information about risks and unusual areas, and to forge greater collaboration with operating managers and work teams.

How does it work?

Control self-assessment is a technique to evaluate the effectiveness of business processes by bringing together individuals in natural work groups and focussing the work group teams on the assessment of steps necessary to assure the achievement of business objectives. A prerequisite is that each work group be given clear written business objectives that have been communicated to the participants. The workshop normally includes a team of individuals and their supervisor. The approach is designed to achieve a sharing of ideas among the people closest to the operations being reviewed to identify the strengths and weaknesses in the existing processes and to formulate improvement plans. The presence of the supervisor ensures a measure of testing action plan suggestions for their feasibility and to allow that supervisor to benefit from the open sharing of perceptions about the work environment.

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Workshop facilitators gain an understanding of unit business objectives through interviews.

The CSA facilitated process would usually occur as follows:

1. The key business objectives are selected for the work unit and are discussed.
2. The work group needs to determine what steps are taken to ensure that objectives are met **and** what improvements can be made to the process surrounding the achievement of the objectives.
3. The targets which could be set to implement such improvements need to be determined. The final step is for the group to determine where they are, currently, in achieving the effectiveness of the control, relative to where they should be. The idea is, to determine priorities for action plans.
4. The output of the workshop is tracked, a summary of the ideas discussed is prepared, and action commitments are made by management.

This process provides an opportunity to gain insights into the soft controls (ethics, management competence, etc.) that may not be a natural outcome of the traditional control evaluation process. Moreover, the flexibility of the process permits it to be at virtually any level of the organisation. An added advantage is the better buy-in to corrective action plans that occurs since such plans are a product of the work group's thinking and experience. Importantly, if there happens to be a smoking gun in the work environment, not only can it be identified, but associated problems can be solved through employee involvement. The fundamental objective of such a programme is to communicate that everyone's overriding responsibility is to improve the business.

(Source: Management Report on Internal Control, 1994:76)

CSA represents a powerful tool for the internal auditor in the quest to achieve the objective of adding value and improving the organisation's operations by gaining first-hand access to employees at all levels and facilitating discussions on risks and controls in their environment. From this the internal auditor gains valuable information to use in the execution of his or her responsibilities.

Answer the questions below.

Question 1

Briefly explain the concepts of governance, risk management and control that are included in the definition of internal auditing.

Question 2

While conducting an internal audit of the security and maintenance facilities of a company's delivery vehicles, you discover that the company is only using security guards and no other methods to protect their assets, even though, collectively, the vehicles are valued at R5 million.

List other preventive and detective controls the company could implement to ensure the effective and efficient physical maintenance and security of its vehicles.

Question 1

• **Governance** is the process put in place by an organisation's top management to manage the organisation in the pursuit of its goals.

• **Risk Management** is the management process used in any organisation to manage the risks that impact on the achievement of the organisation's objectives.

• As defined by the IIA, **control** is any action taken by management, the board and other parties to manage risk and increase the likelihood that established objectives and goals will be achieved.

Question 2

In this question we asked you to list controls, so you did not have to provide any explanation or discussion. If you are asked to "describe" or "explain" the controls, however, you will have to elaborate on each one.
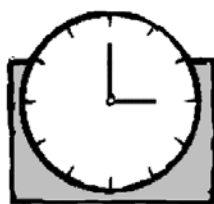
Preventive

• Locks on gates/fences

• Guard dogs

• Lighting

- Maintenance schedules for services

- Regular inspections/services

- Gear locks and alarm systems in vehicles

Detective

- Surveillance cameras on site (could also be preventative)

- Alarms

- Logbooks

- Maintenance records

- Delivery reports

- Surveillance via satellite/radio

TOPIC SUMMARY

This topic provides an overview of the important concepts of governance, risk management and control. The internal auditor's responsibility with regard to each of these concepts was discussed, and from this you should have realised that an internal auditor needs extensive knowledge and understanding of these aspects. Mere factual knowledge is not sufficient, because it will not lead to adequate conceptualisation regarding why internal auditors do what they do. An internal auditor should understand where these concepts fit into the audit process and why each of these aspects should be considered during the conduct of the audit. With this knowledge, internal auditors will be able to discharge any task assigned to them with the necessary professional competence.

Now that you have worked through this topic, are you able to:

- explain the concepts of risk management, control and governance in relation to performing an internal audit?

TOPIC 7: THE INTERNAL AUDIT PROCESS

INTRODUCTION AND PURPOSE OF THE TOPIC

The internal auditing definition states that in rendering their services to the organisation, internal auditors follow a systematic, disciplined approach. In this topic we discuss the internal audit approach, the different types of internal audits and the nature of internal audit work. We identify all the phases in the internal audit process, and explain the nature and function of each phase and the steps to be taken within the different phases.

LEARNING OUTCOMES

When you have worked through this topic, you should be able to

- explain the internal audit approach, the types of internal audits and the nature of internal audit work as determined by the organisation's objectives and requirements.
- describe the phases of the internal audit process and the systematic steps that should be followed during the performance of the internal audit.

CONTENT OF THE TOPIC

This topic is made up of the following learning unit:

Learning unit	Title
7.1	The internal audit process

LEARNING UNIT 7.1: THE INTERNAL AUDIT PROCESS

7.1.1   INTRODUCTION

The performance standards provide guidance with regard to the actual performance of internal audit engagements, starting with the overall planning of all the audits for the year, which falls under managing the internal audit activity (Standard 2000). Standard 2100 Nature of Work follows this and deals with the different phases of the internal audit process.

7.1.2   MANAGING THE INTERNAL AUDIT ACTIVITY

Standard 2000 – Managing the Internal Audit Activity

The chief audit executive must effectively manage the internal audit activity to ensure it adds value to the organisation.

Interpretation*:*

The internal audit activity is effectively managed when:

- *The results of the internal audit activity's work achieve the purpose and responsibility included in the internal audit charter;*

- *The internal audit activity conforms with the Definition of Internal Auditing and the Standards; and*

- *The individuals who are part of the internal audit activity demonstrate conformance with the Code of Ethics and the Standards.*

The internal audit activity adds value to the organisation (and its stakeholders) when it provides objective and relevant assurance, and contributes to the effectiveness and efficiency of governance, risk management, and control processes.

The overall planning phase for the internal audit activity starts with the chief audit executive (CAE) establishing risk-based plans to determine all the work of the internal audit activity for that year. The actual planning with regard to a specific audit engagement is part of the next phase of the internal audit and will be dealt with in the next section of this learning unit.

Standard 2010 – Planning

The chief audit executive must establish a risk-based plan to determine the priorities of the internal audit activity, consistent with the organisation's goals.

Interpretation:

The chief audit executive is responsible for developing a risk-based plan. The chief audit executive takes into account the organisation's risk management framework, including using risk appetite levels set by management for the different activities or parts of the organisation. If a framework does not exist, the chief audit executive uses his/her own judgment of risks after consideration of input from senior management and the board. The chief audit executive must review and adjust the plan, as necessary, in response to changes in the organisation's business, risks, operations, programs, systems, and controls.

> **2010.A1 –** The internal audit activity's plan of engagements must be based on a documented risk assessment, undertaken at least annually. The input of senior management and the board must be considered in this process.
>
> **2010.A2** – The chief audit executive must identify and consider the expectations of senior management, the board, and other stakeholders for internal audit opinions and other conclusions.
>
> **2010.C1 –** The chief audit executive should consider accepting proposed consulting engagements based on the engagement's potential to improve management of risks, add value, and improve the organisation's operations. Accepted engagements must be included in the plan.

These plans should be communicated (**Standard 2020**) to senior management and the board for review and approval. The annual plan should also address the resources (**Standard 2030**) needed to perform the audits by looking at the number of people needed, the skills and experience they should have and whether or not the required audit tools are available.

The CAE should establish policies and procedures (**Standard 2040**) to guide the internal audit staff and is also responsible for the coordination (**Standard 2050**) of other parties involved.

Finally the CAE should report (**Standard 2060**) on the performance of the department relative to its plan, to senior management and the board.

Managing the internal audit activity is the duty of the CAE, and this topic will be dealt with in detail in the third-year modules.

The internal audit process can differ dramatically from assignment to assignment, depending on both the nature and scope of work. Note that the above discussion relates to the management of the internal audit activity and its planning for areas of coverage, and not the individual audits or engagements. Each individual audit engagement has different characteristics. The general phases of an internal audit engagement are discussed in section 7.1.4 of this learning unit.

7.1.3 TYPES OF INTERNAL AUDIT ENGAGEMENTS AND ENGAGEMENT APPROACHES

7.1.3.1   Types of internal audits

Different types of audits can be performed. There is no fundamental difference in the underlying philosophy of the types of audits to be discussed below. They all strive to improve organisational performance. The differences lie in the aspect of performance on which they focus.

In this learning unit, we provide a brief overview of the following types of audits:

1.   **Compliance audits**

Compliance audits are carried out to determine whether a business entity has complied with specific policies, plans, procedures, laws, regulations or contracts, which affect the organisation. In order to complete a compliance audit successfully, there must be established criteria against which the compliance can be measured (Cascarino 2007:127).

The focus of compliance auditing is on compliance with laws and regulations, statutes and internal policies. Therefore, a compliance audit sets out to find out how well a unit or organisation complies with an established set of "rules". Clearly, the level of compliance

with formal rules is an aspect of performance. Although it is an important aspect, it is not the only one with which an auditor is concerned.

2.   Financial audits

During a financial audit, an auditor looks for evidence relating to the reliability and integrity of financial information. When an internal auditor conducts such audits, the information is normally intended to be used by management for internal decision-making purposes. The audit may involve both operating and financial data. Financial audits normally include a review of the accuracy and completeness of the numbers themselves, and an evaluation of the adequacy and effectiveness of the controls that management have implemented to safeguard assets.

Auditing of financial statements is directed at assessing the accuracy of financial reports relating to financial conditions and operating performance. This type of auditing is usually associated with external audits and includes ensuring the fairness of financial reporting (Cascarino 2007:127–128)

3.   Performance audits

Performance auditing and operational auditing deal with the extent to which a unit meets its performance objectives (effectiveness) and how well it utilises resources (efficiency and economy) (Cascarino 2007:127).

Performance auditing involves firstly determining management's objectives, followed by establishing whether the existing management controls will lead to effectiveness, efficiency and economy. An auditor must determine

- which key performance indicators are used
- whether they are appropriate
- whether control objectives have been achieved in an effective, efficient and economical manner

4. **Environmental audits**

During a typical environmental audit, a team of qualified inspectors conducts a comprehensive examination of a plant or other facility to determine whether it is complying with environmental laws and regulations. There is, however, a distinction between a compliance audit and an evaluation of whether an organisation is complying with environmental laws and regulations. The team systematically verifies compliance with applicable requirements using professional judgement and evaluations of on-site conditions. The team may also evaluate the effectiveness of systems in place to manage compliance and assess the environmental risks associated with the facility's operations.

Effective environmental audit programmes have a number of characteristics in common. They require the strong support of their organisation's management as well as adequate allocation of resources to hire and train audit personnel. In addition, to be effective, audit programmes must operate with freedom from internal or external pressure and employ quality assurance procedures to ensure the accuracy and thoroughness of audits (Cascarino 2007:p128).

5. **Fraud audits or investigations**

Fraud auditing involves helping management create an environment that encourages the detection and prevention of fraud in commercial transactions (see Topic 5). This may involve helping to set a standard for the organisation with an appropriate code of conduct and conflict-of-interest policy.

A fraud auditor must know

- the realm of fraud possibilities (How can it happen?)
- the sources of information and evidence (Where do I look?)
- whether the environment is conducive to fraud (Is fraud likely?)
- the areas of fraud opportunity (Where can it happen?)
- the laws of evidence (How can I prove it?)

A fraud auditor must be capable of conducting a review of internal controls, assessing the strengths and weaknesses of those controls, identifying abnormal transactions and distinguishing between errors and fraudulent entries. This may involve following a computerised audit trail.

A fraud auditor is responsible for determining whether an irregularity has occurred and, if so, whether there is a criminal law in terms of which the matter can be dealt with, and whether there is an apparent breach of that law, since not all fraud can be prosecuted under criminal law.

An auditor must be alert to red flags and indicators, such as personal behaviour pattern changes, substantial departmental growth or decline beyond the norms.

Fraud detection may be reactive, in which case an auditor reacts to allegations and complaints, suspicions and management's intuition. Proactive auditing involves ensuring adequate internal controls through periodic audits, intelligence gathering, reviewing of variances, or logging of exceptions (Cascarino 2007:p129).

6. Quality audits

Quality audits may be defined as a systematic and independent examination to determine whether quality-related activities are implemented effectively and are complying with the quality systems and/or quality standards.

As seen by auditors, quality audits are not the same as quality assurance in the normal sense of the word, which is usually associated with excellence. "Quality audits" is a technical term for auditing that is focused on systems and processes rather than outcomes. This follows the corporate governance concept that the properly constituted organisation should be based on a system of well-controlled systems and processes.

Quality audits have become associated with older forms of management of quality such as total quality management (TQM). As such, quality audits are associated with quality enhancement strategies rather than the traditional quality control inspections. Quality enhancement focuses on creating a corporate culture centred on quality, as opposed to quality control, which was a reactive process after the event, and involved rejecting sub-standard products and services.

If quality is viewed in terms of the appropriateness of systems and processes rather than the more traditional achievement of the correct outcomes, auditing moves from the need to define best practice and desirable outcomes to evaluating the quality of the processes themselves. Defining the key performance indicators has always been a contentious point in negotiating with management for the audit. Reaching agreement on standard systems of practice is normally considerably easier, since little interpretation is required. From this, it follows that a proper organisational structure is comprehensively systemised and documented, and therefore fully auditable (Cascarino 2007:p130).

7.   Programme results audits

Programme results audits aim to measure the accomplishment of established goals and objectives for operations and programmes. In practical terms, it means audits that determine whether the desired results are being achieved, as well as whether management has considered other options to achieve the same results at a lower cost.

Conducting such audits involves

- ascertaining whether a specific objective or goal has been clearly defined for a particular function
- ascertaining whether the objectives or goals are relevant and consistent with management's intent
- evaluating any variance between the results and their original stated goals and objectives

In addition, the cost-effectiveness of a given programme is evaluated, as it is the cost benefit of continuing a programme. Many auditors use statistical analysis extensively over a period, drawing inferences from the results of the statistics. Complaint records may give a good indication of the extent to which given operations of programmes satisfy the needs of the target market. Management themselves may well be able to give advice on the appropriateness of the programmes and the measurement criteria (Cascarino 2007:p131).

8. Information Technology (IT) and Information Systems (IS) audits

IT audits come in a variety of forms. Any of the above types of internal audits could involve the use of computers or, for that matter, the auditing of computer systems (Cascarino 2007:p131)

7.1.3.2   Internal audit approach

The internal audit approach describes the methodology the internal auditor will follow to achieve the audit objective (engagement objective) in the most efficient way. The engagement objectives describe what the internal auditor wants to achieve by performing an audit.

The most commonly accepted and practised approach to an internal audit, is the **risk- based** audit approach. This approach replaced the compliance-based approach in which compliance with existing procedures and processes is assessed without an evaluation of whether or not the procedure or process is an adequate control. A risk-based approach is more effective as it allows internal audit to determine whether controls are effective in managing the risks which arise from the strategic direction that a company, through its board, has decided to adopt (King III).

The risk-based internal audit (RBIA) approach

Risk-based internal auditing (RBIA) is the methodology that provides assurance that risks are being managed within the organisation's risk appetite. This approach is also recommended for internal audit activities in the King III report

To evaluate the success of senior management's risk management, the internal auditor should be able to identify the risks that may prevent the organisation from achieving its objectives. As risks are the uncertain events that could influence the objectives, the internal auditor and senior management have to know and agree on exactly what the objectives of the organisation are before they can begin to identify the risks involved.

The internal auditor must be familiar with the risk management techniques and methods used by senior management so that he or she can evaluate the level of success with which senior management has implemented its risk management process.

RBIA is one of many opinions on corporate governance provided to the board and the audit committee by the internal auditor. These opinions are conventionally known as "assurance", which includes the opportunity to indicate why assurance cannot be given, in part or as a whole. In this course, when using the term "assurance", we also include the possibility that RBIA has found that not all risks are managed properly and, therefore, assurance cannot be given.

In implementing RBIA, the assurance required by the board from various functions (e.g. health and safety, quality control, insurance, the external auditors) will have to be taken into consideration, and this should be reflected in the internal audit activity's charter (terms of reference). It is the responsibility of the internal audit activity to fulfil the board's requirements; it is the board's responsibility to fulfil the requirements placed on it by legislation and stakeholders.

The methodology consists of the following five core internal audit roles that cover the risk management framework of the whole organisation (known as "enterprise-wide risk management" – ERM):
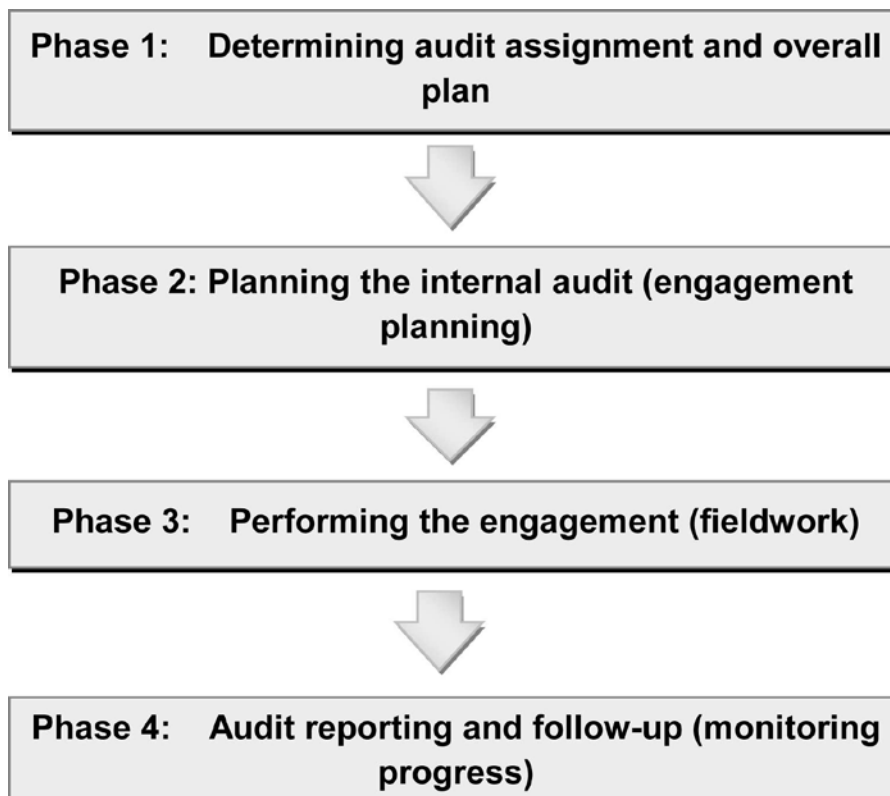
a. Give assurance that the processes used by management to identify all significant risks are effective.

b. Give assurance that risks are correctly assessed (scored) by management, in order to prioritise them.

c. Evaluate risk management processes, to ensure the response to any risk is appropriate and conforms to the organisation's policies.

d. Evaluate the reporting of key risks, by managers to directors.

e. Review the management of key risks by managers to ensure that controls have been put into operation and are being monitored.

7.1.4 STEPS IN THE INTERNAL AUDIT PROCESS

The internal audit process consists of systematic audit phases (and associated steps within each phase) that should be followed for a specific audit engagement to achieve the audit objectives.

Although the ultimate purpose of any internal audit is to produce a report to management to help members of the organisation achieve the organisational objectives, the objective and/or nature and/or scope of an audit may differ due to the unlimited variety of internal audits that can be performed to achieve the specified audit objectives. There is no single uniform audit process that is valid for all audits, although there are fundamental phases in the process that are applicable to almost all internal audits.

To conduct an efficient and effective internal audit, the internal audit process should include the following four phases:

Phase 1: Determining audit assignment and overall plan

Phase 2: Planning the internal audit (engagement planning)

Phase 3: Performing the engagement (fieldwork)

Phase 4: Audit reporting and follow-up (monitoring progress)

PHASE 1: DETERMINE THE AUDIT ASSIGNMENT AND OBJECTIVES (AUDITING ENGAGEMENT)

The starting point of any internal audit is knowledge of the internal audit charter and adherence to its provisions. The internal audit charter may be seen as a contract that formalises the relationship between the internal audit activity and the organisation. The charter is developed by the management and board of the organisation in conjunction with the internal auditor, because these provisions determine the overall purpose, authority and responsibility (job description) of the internal audit activity. These provisions should be consistent with the requirements of the Standards, and approved by the board. The charter is approved to give it the necessary status in the organisation.

Refer to Topic 5 for an example of an Internal Audit Charter.

Also study Standard 1000 and Practice Advisory 1000–1 with regards to the internal audit charter.

The nature of the audit assignment

The audit engagement could be a specific internal audit assignment, an assurance audit, or a review or consultancy engagement. An engagement may include multiple tasks or activities designed to accomplish a specific set of related objectives. It could be an operational audit, or a financial audit of the different business processes, an IT audit, internal control review, fraud detection, control self-assessment review or a combination of them all.

The origin of the audit assignment

The audit assignment originates from a risk assessment performed annually by the internal audit department (refer to Topic 6).

According to Standard 2010 "the chief audit executive should establish risk-based plans to determine the priorities of the internal audit activity, consistent with the organisational goals" and also provide in his annual budget for the execution of normal and special ad hoc assignments.

An internal audit department conducts its audit assignments primarily based on two sources, namely,

1. the normal annual planning (risk assessment) of the internal audit department in accordance with the authorised budget of the department (Standard 2010.A1)

2. special assignments (Standard 2010.C1) which are initiated either

   - from within the internal audit department itself, based on findings, special developments, (ad hoc audits) or

   - by members of the organisation via management (auditee requests).

The normal planning of the audit assignment should be based on a risk assessment, performed at least annually, that considers the input of senior management and the board of directors. This plan will enable the CAE to prioritise internal audits in a manner that is consistent with the broader organisational objectives. The CAE prepares an annual plan to ensure that all the major organisational objectives and risks will be adequately and appropriately covered by internal audit. Internal audit assignments for normal planned audits should also be formulated in writing and discussed with the internal auditor responsible for their performance. This procedure contributes toward a better understanding of what the audit assignment entails, and serves as basis for the next phase.

As manager of the internal audit department, the CAE should consider accepting proposed consulting engagements based on the engagement's potential to improve management of risks, add value, and improve the organisation's operations. The CAE should determine procedures for the handling of, coordination of, and control over the receiving and performance of special audit assignments. In practice, when such procedures are not applied, special assignments, either

- do not receive the appropriate attention; or

- they receive excessive attention, to the detriment of the previously planned routine internal audits referred to in (1) above.

The procedure for handling, coordinating and controlling special audit assignments must make provision for the following five points:

1. Receipt, written formulation, documentation and filing of special audit assignments at a central place.

2. Determination of the priority which special audit assignments will enjoy with regard to their execution.

3.   Written authorisation by the CAE, bearing in mind the availability of budgeted time, for the execution or rejection of special audit assignments, together with the appropriate notification of his or her decision to the initiator of the special assignment.

4. Discussion of the authorised, ranked, written audit assignment with the CAE responsible for the performance of the particular special audit task.

5.   After that, the special assignment should follow the procedures prescribed for normal planned budgeted internal audits.

Content of the audit assignment

The written formulation and authorisation by the initiator of the audit assignment, regarding the need for the internal audit assignment, its scope, and the restrictions imposed, help to ensure that all parties concerned, namely,

- the responsible internal auditor;
- the chief audit executive (CAE); and
- management

clearly understand the need from which the audit assignment originated, the limits within which the audit is to be performed, and what could be achieved by the internal audit.

In internal audits, the limiting factors that pertain to it are not as clearly demarcated as is the case with ordinary external audits, and to prevent vagueness causing misunderstandings, this step is essential. Clearly, setting the scope of an engagement upfront prevents mismatched expectations.

This audit assignment document remains the internal auditor's guideline throughout the subsequent execution of the audit assignment. All his or her subsequent acts should be aimed at satisfying the formulated need (objective) which initiated the audit assignment. The internal auditor's final audit opinion should in fact fulfil this need specifically.

PHASE 2: PLANNING THE INTERNAL AUDIT (ENGAGEMENT PLANNING)

The prerequisite for conducting an efficient internal audit is proper planning.

Engagement planning comprises the approaches and actions the internal auditor must develop and record for every audit assignment (engagement), including the scope, objectives, timing and resource allocation. Proper planning will ensure that each step is fully applied and that the

steps are followed systematically in the correct order. The correct order must be followed because each planning step is influenced by the previous step(s).

Planning is not confined to the initial stage of the audit but is an ongoing process until the fieldwork has been completed. Information acquired during the audit and/or changing circumstances can have an impact on the planning and conducting of the rest of the audit.

Standard 2200 – Engagement Planning

Internal auditors must develop and document a plan for each engagement, including the engagement's objectives, scope, timing and resource allocations.

Standard 2201 – Planning Considerations

In planning the engagement, internal auditors must **consider**:

- The objectives of the activity being reviewed and the means by which the activity controls its performance;
- The significant risks to the activity, its objectives, resources and operations, and the means by which the potential impact of risk is kept to an acceptable level;
- The adequacy and effectiveness of the activity's risk management and control processes compared to a relevant control framework or model; and
- The opportunities for making significant improvements to the activity's risk management and control processes.

2201.A1 – When planning an engagement for parties outside the organisation, internal auditors must establish a written understanding with them about objectives, scope, respective responsibilities and other expectations, including restrictions on distribution of the results of the engagement and access to engagement records.

2201.C1 – Internal auditors must establish an understanding with consulting engagement clients about objectives, scope, respective responsibilities and other client expectations. For significant engagements, this understanding must be documented.

Steps in planning the internal audit

The planning steps that should be followed for each audit are:

1. Obtain background information of the audit area. (preliminary survey).
2. Identify the engagement objective(s) to be achieved.

3. Consider the audit risk.

4. Determine the allocation of engagement resources.

5. Compile the detailed engagement (audit) programme.

Let us discuss these steps in more detail.

(Step 1) Background knowledge (preliminary survey)

It is important to obtain background information on the audit area in a planned and systematic manner. Not all information related to the audit area is necessarily important to achieve the objectives of the audit.

Even at the planning stage the internal auditor's approach should be management- and risk-based orientated, that is to say comprehensive information on the activity or department to be audited should be collected. This comprises far more than collecting information on the nature of transactions, the flow of transactions and documents and the accompanying controls.

The reasons for obtaining background information on the auditee are to:

- Obtain knowledge of the environment and business practices applicable to that business;
- Be able to identify the business processes put in place;
- Evaluate the effectiveness and efficiency of the processes;
- Identify processes that do not assist with the achievement of the objectives.

It is also stated in Standard 2201.A1 that "When planning an engagement for parties outside the organisation, internal auditors must establish a written understanding with them about objectives, scope, respective responsibilities, and other expectations, including restrictions on distribution of the results of the engagement and access to engagement records."

A review of background information should, therefore, be performed to obtain an understanding of the organisation and its processes, and to determine the impact on the engagement. Relevant items may include (Practice Advisory 2210.A1-1):

- Objectives and goals (organisational)
- Policies, plans, procedures, laws, regulations and contracts, which could have a significant impact on operations and reports

- Organisational information, e.g., number and names of employees, key employees, job descriptions, and details about recent changes in the organisation, including major system changes
- Budget information, operating results, and financial data of the activity to be reviewed
- Prior engagement working papers
- Results of other engagements, including the work of external auditors, completed or in process
- Correspondence files to determine potential significant engagement issues
- Authoritative and technical literature appropriate to the activity

(Step 2) Identify the engagement objective(s) to be achieved

What are engagement objectives?

According to the internal auditing standards, **engagement objectives (sometimes also referred to as audit objectives) are broad statements developed by the internal auditor that define the intended engagement accomplishments**. These statements will not limit the scope of the investigation and will ensure that the purpose of the engagement is still accomplished. Based on the information and evidence obtained during the preliminary survey (Step 1), the auditors will determine the objectives of the audit engagement. The objectives must enable the internal auditors to add value to and improve the operations of the engagement activity (department/section/ unit audited), as well as those of the organisation as a whole.

While performing the preliminary survey (step 1) the internal auditor should identify the organisational (business) objectives.

Engagement (or audit) objectives depend on organisational objectives. The engagement (audit) objective(s) should be established for each audit engagement and should be formulated with reference to the following:

- the provisions of the charter,
- the requirements of the audit committee,
- the origin of the audit assignment, and
- the consideration of the risk assessment.

Study the following Standard with regard to engagement objectives:

Standard 2210 – Engagement Objectives

Objectives must be established for each engagement.

> 2210.A1 – Internal auditors must conduct a preliminary assessment of the risks relevant to the activity under review. Engagement objectives must reflect the results of this assessment.
>
> 2210. A2 – Internal auditors must consider the probability of significant errors, fraud, noncompliance and other exposures when developing the engagement objectives.
>
> 2210. A3 – Adequate criteria are needed to evaluate controls. Internal auditors must ascertain the extent to which management has established adequate criteria to determine whether objectives and goals have been accomplished. If adequate, internal auditors must use such criteria in their evaluation. If inadequate, internal auditors must work with management to develop appropriate evaluation criteria.
>
> 2210. C1 – Consulting engagement objectives must address governance, risk management and control processes to the extent agreed upon with the client.
>
> 2110. C2 – Consulting engagement objectives must be consistent with the organisation's values, strategies, and objectives or goals.

Formulation of engagement/audit objectives

It is very important to formulate audit objectives correctly, otherwise there will be no clarity on exactly what the internal auditor is expected to achieve by conducting the audit.

> **NB**: Therefore the engagement/objective is what the internal auditor wishes to ensure by his or her testing (audit procedures).

(Step 3) Consider the audit risk

The internal auditor should make a preliminary assessment of audit risk which are uncontrollable by the internal auditor and may impact on the achievement of engagement (audit) objectives.

Three risks need to be considered when considering audit risk. They are inherent risk, control risk and detection risk.

Audit risk

Audit risk will be discussed in more detail in the internal auditing modules at the third level. For the purpose of this module, you need to understand the meaning of audit risk and the components of audit risk and be able to calculate audit risk.

Audit risk is the risk that audit coverage will not address significant business exposures

The total audit risk is determined by means of the following formula:

IAR (internal audit risk) = IR (inherent risk) x CR (control risk) x DR (detection risk)

1. Inherent risk

    Inherent risk is the likelihood of a significant loss occurring before any risk-reducing factors are taken into account.

    In evaluating inherent risk, an auditor should consider the types and nature of the risks and what factors indicate that a risk exists.

2. Control risk

    Control risk is the likelihood that the control processes established to limit or manage inherent risk are ineffective.

    To ensure that internal audit evaluates the controls properly, an auditor must understand how to measure the effectiveness of controls. This will involve identifying those controls that provide the most assurance that risks are being minimised within the business.

It is quite clear from the descriptions of inherent and control risks that, when the risk approach in the conduct of an audit is followed, these risks should serve as the basis for establishing the auditor's exposure to risks.

3.   Detection risk

Detection risk is the risk that the auditors might not pick up material problem that would affect the conclusion pertaining to an audit objective.

This might arise because entries and activities are not fully examined.

The term "material" indicates significance. The internal auditor should consider materiality and its relationship to the audit risk when conducting an audit.

(Step 4) Determine the allocation of engagement resources

This step will be discussed in more detail in the internal auditing modules at the third level. For the purposes of this module, you need to know and understand the following standard with regard to engagement resources.

Standard 2230 – Engagement Resource Allocation

Internal auditors must determine appropriate and sufficient resources to achieve engagement objectives based on an evaluation of the nature and complexity of each engagement, time constraints and available resources.

(Step 5) Compile the engagement/audit programme

According to Sawyer (2003:219), the audit or engagement programme lists directions for the examination and evaluation of the information needed to meet audit objectives within the scope of the audit assignment.

The nature and extent of the audit procedures that should be performed during the fieldwork phase are determined by considering the results of all the previous steps in the planning process, and are then set out in the form of a written audit programme. The audit programme is the result of the initial planning steps. The thoroughness with which the audit programme is compiled will directly determine the efficiency of the audit.

Standard 2240 – Engagement Work Programme

Internal auditors must develop and document work programmes that achieve the engagement objectives.

> 2240. A1 – Work programmes must include the procedures for identifying, analysing, evaluating and documenting information during the engagement. The work programme must be approved prior to its implementation, and any adjustments approved promptly.

> 2240.C1 – Work programmes for consulting engagements may vary in form and content depending upon the nature of the engagement.

PHASE 3: PERFORMING THE ENGAGEMENT (FIELDWORK)

Phase 3 of the audit process is where the audit procedures as set out in the audit programme are conducted and evidence is gathered to satisfy the audit objectives.

The results of the audit procedures performed are captured on working papers, which we discuss in more detail in the next learning unit.

The Standards require the following with regard to performing the engagement:

Standard 2300 – Performing the Engagement

Internal auditors must identify, analyse, evaluate and document sufficient information to achieve the engagement's objectives.

Standard 2310 – Identifying Information

Internal auditors must identify sufficient, reliable, relevant and useful information to achieve the engagement's objectives.

Interpretation:

Sufficient information is factual, adequate and convincing, so that a prudent, informed person would reach the same conclusions as the auditor. Reliable information is the best attainable information through the use of appropriate engagement techniques. Relevant information supports engagement observations and recommendations, and is consistent with the objectives for the engagement. Useful information helps the organisation meet its goals.

Audit evidence

Audit evidence involves all forms of information that the internal auditors consider necessary to achieve their audit objective.

In view of the wide-range and important function of audit evidence in the internal audit process, it is necessary to discuss the concept in more detail. The basic task of internal auditors is to obtain sufficient acceptable audit evidence to enable them to carry out their responsibilities as efficiently as possible.

Our discussions of audit evidence in this module are confined to indicating the kinds of audit evidence that are available and are normally used and the standards with which audit evidence should comply.

(a) Kinds of audit evidence

There are numerous kinds of audit evidence, all of which are likely to be used at some stage of the audit. Various audit objectives require the gathering of various kinds of audit evidence or a combination of different kinds of audit evidence.

Physical evidence

Physical evidence is obtained through the **direct observation** of people, property and events. It can take the form of attendance at a physical stock count and/or attendance at wage pay-outs. In the latter case, it is preferable for two or more internal auditors or a physical representative of the auditee to participate in the observation. This will ensure that the second person confirms or notes the observation, that is, one person checks and the other records the evidence.

Oral evidence

Oral evidence is gathered in the course of interviews or enquiries. Generally, this type of evidence must be supported by documentation or other evidence.

Documentary evidence

Documentary evidence comprises the documents of the auditee which relate to the auditee's business. This type of evidence may be internal or external. External documentary audit evidence originates outside the undertaking and includes letters or memoranda received by the auditee, suppliers' invoices, credit notes received, bank statements and packing sheets.

Internal documentary evidence originates within the undertaking and includes sales invoices, paid cheques, credit notes issued and copies of outgoing correspondence.

The source of documentary evidence determines its acceptability. Under normal circumstances, an external document obtained directly from its source has greater persuasive value than a document prepared by the auditee (e.g. a letter of confirmation from a bank in respect of a fixed deposit held). Internal documents can be manipulated or generated by a system that has weak controls.

Evidence generated by the internal auditor

This type of evidence is related to analysis and confirmation. The sources of such evidence are calculations, comparisons with imposed standards, completed operations, similar operations and the combining of information in context. The latter requires the logical assessment of existing and generated information. Some examples here are the use of the total control system (the largest and most important kind of audit evidence), the environment in which the organisation is active, general economic conditions, the interrelationship of activities and data, and analogy.

(b) Standards with which audit evidence must comply

Four important attributes that the auditor needs to consider carefully when performing an audit test are the sufficiency, competence, relevance and usefulness (see Standard 2310) of audit evidence. These will depend on the nature, timing and scope of the internal audit procedures that are being applied.

Audit evidence should be sufficient, reliable, relevant and useful:

Sufficient

Evidence is sufficient if it is so factual, adequate and convincing that it would lead a prudent, informed person to the same conclusions as the internal auditor. It requires objective judgement on the internal auditor's part.

Reliable

Reliable evidence is the best attainable through the use of appropriate engagement techniques. So, for example, an original document is more conclusive (reliable) than a copy, and direct evidence is more acceptable than hearsay evidence.

Relevant

Relevant information supports engagement observations and recommendations and is consistent with the objectives for the engagement. The facts and opinions used to prove an issue must bear a logical relationship to that issue. For example, an original purchase order, properly approved and issued, has no relevance if the auditor wants to determine whether the goods have actually been received.

Useful

This term refers to information that helps the organisation meet its goals.

The basic categories of engagement/audit procedures

Audit procedures are the tests that the auditor performs during the audit. The basic categories of engagement procedures to obtain audit evidence are the following:

- **Inspection**

  Inspection involves examinations of records or documents, whether internal (originating within the company) or external (originating outside the company), in paper form, electronic form or in the form of other media, or a physical examination of an asset.

- **Observation**

  This consists of looking at a process or procedure being performed by others. It implies taking a careful and knowledgeable look at people's activities and actions in order to obtain information that the internal auditor requires to perform his or her task. Observing is a valuable procedure, which is used in virtually every assignment and which requires a high degree of skill. Observations are sometimes carried out subtly and inconspicuously. Information obtained when the auditee is unaware that he or she is under observation, and so does not carry out procedures purely to satisfy the internal auditor, is very valuable.

- **External confirmation**

  Obtaining external confirmation entails receiving a direct written response from a third party to a request from the auditor to that third party.

- **Recalculation**

  Recalculation consists of checking the mathematical accuracy of documents and records manually or electronically.

- **Routine checking/transaction audit**

  Basically, the routine work in an internal audit (original record examination) comprises those steps (checks) designed to satisfy the internal auditor that the double-entry functions have been fully and correctly performed. In particular, auditors need to be satisfied regarding

  1. additions
  2. cross-casts
  3. extensions
  4. analysis
  5. transfer of totals
  6. calculation of balances
  7. postings in the books of account.

  Routine checking is, therefore, essentially concerned with checking on the arithmetical accuracy of the books of prime entry, the correct postings to the appropriate account and type of account in the ledgers, and the correct balancing of the books, accounts and statements.

  Routine checking lends itself perfectly to the application of sampling or testing techniques and, because accounting procedures are obviously very important here; this is an area where the internal auditor may rely largely on an efficient system of internal controls. A balanced trial balance, control accounts agreeing with the aggregate of individual personal accounts, or proven reconciliation statements are specific factors that indicate that at least the relevant section of the system of internal controls is being maintained.

- **Reperformance**

  The auditor independently executes procedures or controls that were originally performed as part of the entity's internal control (e.g. reperformance of a bank reconciliation).

- **Analytical procedures**

  Analytic procedures consist of evaluating financial information through analysis of plausible relationships among financial and non-financial information.

- **Verification/ audit of balances**

Verification consists of checking, examining and/or obtaining satisfactory evidence (i.e. to prove that something exists or is accurate) that all assets and liabilities of the undertaking that are (or should be) shown on the balance sheet

1. do exist;
2. are in fact the property, or liability, of the undertaking;
3. are shown at a fair valuation;
4. are all disclosed in conformity with generally accepted accounting principles and/or specific legal requirements; and
5. that the auditor has satisfied himself of the preceding facts in respect of every item separately, and of the balance sheet as a whole.

The objective of verification, therefore, is to satisfy the internal auditor that all transactions entered into during the financial period in question, and only those transactions, have been included in the financial statements and other internal reports. Verification procedures are mostly used in financial audits.

- **Inquiry**

Inquiry entails seeking information, both financial and non-financial from knowledgeable persons within or outside the entity. This can be done by questioning and interviewing the relevant people.

- **Tracing**

This involves the selection of documents for tracing to the relevant entries recorded in the accounting records. The direction of testing allows for the detection of entries omitted and, therefore, provides assurance related to the completeness assertion.

- **Computer-Assisted Audit Techniques (CAATs)**

When the entity's accounting records are maintained on electronic media, CAATs may be used to perform many audit procedures. The use of CAATs may provide effective tests of controls and substantive procedures where there are no input documents or a visible audit trail, where population and sample sizes are very large or where it may not be possible to perform the procedures manually

(Extracted and adapted from Auditing Notes for South African Students)

Compilation of an audit procedure

An audit procedure has a certain structure. It must start with a verb. For example:

- **inspect** (**only** a document can be inspected)
- **observe** (**only** an action can be observed)
- **reperform**
- **compare**
- **verify**
- **enquire**, etc.

An audit procedure must be stated in full explaining clearly what you want to do and why, and what information you will use.
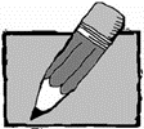
Provide examples of how the internal audit procedures "observing", "inquiry" and "verification", can be applied in an inventory count.

Observing
- o Observe and note areas where high-value items are stored.
- o Observe inventories that may be troublesome, such as those types which are difficult to count.
- o Observe whether the count is being done competently, conscientiously and in accordance with instructions.
- o Observe whether the tags or count sheets are being properly written up.
- o Observe whether the counter and recorder note any deterioration of inventory overlooked at prior sorting.
- o Observe whether the count checking procedure is proceeding according to instruction.
- o Observe the manner in which the inventory count is completed

Inquiry
- o Inquire from inventory management to describe the procedures laid down for testing the inventory records.
- o Ask the storeman how he identifies slow-moving or obsolete inventory items during the inventory count.

Verification/audit of balances
- o Note the cut-off point and trace some of the receipts and issues just before and after cut-off, per relevant documents, to the entries on the inventory records to verify that the dates agree.
- o Conduct test counts of items and verify that the quantities concur with the balances on the relevant inventory records; investigate and clear any differences.

PHASE 4: AUDIT REPORTING AND FOLLOW UP (MONITORING PROGRESS)

The entire audit culminates in a report to the management of the organisation. The fulfilment of the objectives of the internal audit activity is largely dependent on the quality of reporting. It must contain persuasive arguments for change where change is necessary. Matters should also be discussed with the client during the course of the audit as the picture is developed through the analysis and evaluation carried out by the auditor, with help from the client. The impact of the report must be such that the reader is immediately convinced. Such a report is efficient and effective.

At the follow-up stage checks whether agreed actions and decisions have been fully implemented and whether the adopted risk management strategy is working well.

At this level of study we confine ourselves to a study of the provisions of the internal auditing standards regarding the basic requirements with which an internal auditor's report should comply.

Standard 2410 – Criteria for Communicating

Communications must include the engagement's objectives and scope as well as applicable conclusions, recommendations, and action plans.

2410.A1 - Final communication of engagement results must, where appropriate, contain the internal auditors' opinion and/or conclusions. When issued, an opinion or conclusion must take account of the expectations of senior management, the board, and other stakeholders and must be supported by sufficient, reliable, relevant, and useful information.

Interpretation: Opinions at the engagement level may be ratings, conclusions, or other descriptions of the results. Such an engagement may be in relation to controls around a specific process, risk, or business unit. The formulation of such opinions requires consideration of the engagement results and their significance.

2410.A2 – Internal auditors are encouraged to acknowledge satisfactory performance in engagement communications.

2410.A3 – When releasing engagement results to parties outside the organisation, the communication must include limitations on distribution and use of the results.

2410.C1 – Communication of the progress and results of consulting engagements will vary in form and content depending upon the nature of the engagement and the needs of the client.

What should be done before an audit report can be issued?

Audit reporting begins with observations/findings about the audit and the internal auditor's recommendations for addressing any problems identified during the audit. These observations and recommendations emerge during the process of comparing what should be with what is. Whatever the results of this process, they give the internal auditor something on which to base the report. If the auditee has met all the criteria, it is appropriate to acknowledge satisfactory performance in the report.

Therefore for any observation identified during the audit, the internal auditor should compile an **audit finding**. An audit finding should contain the following elements.

- **Criteria**: the standards, measures or expectations used for evaluating and/or verifying (what should exist).

- **Condition**: the factual evidence that the internal auditor has found in the course of the examination (what does exist).

- **Cause**: the reason for the difference between the expected and actual conditions (why the difference exists).

- **Effect**: the risk or exposure the organisation and/or others encounter because the condition is not consistent with the criteria (the impact of the difference). In determining the degree of risk or exposure, internal auditors should consider the effect of their audit observations and recommendations on the organisation's strategic objectives.

- **Recommendations**: the possible remedies to address and correct the finding in future. The recommendation should address the cause of the finding.

Conclusions (opinions) are the internal auditor's evaluations of the effects of the observations and recommendations on the activities reviewed. These conclusions usually put the observations and recommendations in perspective, taking their overall implications into account. Audit conclusions, if included in the audit report, should be clearly identified as such Audit reports should include recommendations for improvement, acknowledgements of satisfactory performance and corrective action

Recommendations are based on the internal auditor's observations and conclusions. They call for action to correct existing conditions or to improve operations. The recommendations may act as a guide for management to achieve certain results by suggesting approaches for correcting or enhancing performance; these recommendations may, therefore, be general or specific.

The accomplishments of audit clients, in terms of improvements that have been effected since the last audit or the establishment of a well-controlled operation, may be included in the final report. This information may be necessary to present the existing conditions fairly and to give a proper perspective and appropriate balance to the final report. The auditee's views about the audit conclusions or recommendations may be included in the report.

As part of the internal auditors' discussions with the auditee, they should try to get consensus on the results of the audit and on a plan of action to improve operations where necessary. If the internal auditor and the client disagree on the audit results, the report may state both positions and the reasons for the disagreement. The auditee's written comments may be included as an appendix to the report or may be presented in the body of the report or in a covering letter.

Certain information may not be appropriate for disclosure to all report recipients, because it is privileged or proprietary, or related to improper or illegal acts. Such information may, however, be disclosed in a separate report. If the conditions being reported on involve senior management, the report will only be distributed to the directors of the organisation or the audit committee.

Interim reports are prepared and issued while the audit is in progress. Interim reports may be oral or written and may be transmitted formally or informally. They may be used to communicate information that requires immediate attention, to communicate a change in audit scope for the activity under review, or to keep management informed of the progress of the audit if it extends over a long period. The use of interim reports does not reduce or eliminate the need for a final report.

A signed written report should be issued after the audit has been completed. Summary reports highlighting audit results may be appropriate for levels of management above the audit client (auditee). These may be issued separately from or in conjunction with the final report. The word "signed" means that the authorised internal auditor's name should be manually signed in the report. Alternatively, the signature may appear on a covering letter. The internal auditor authorised to sign the report should be designated by the chief audit executive. If audit reports are distributed electronically, a signed version of the report should be kept on file by the internal audit activity.

Standard 2420 – Quality of Communications

Communications must be accurate, objective, clear, concise, constructive, complete, and timely.

Interpretation:

*Accurate communications are free from errors and distortions and are faithful to the underlying facts. **Objective** communications are fair, impartial, and unbiased and are the result of a fair-minded and balanced assessment of all relevant facts and circumstances. **Clear** communications are easily understood and logical, avoiding unnecessary technical language and providing all significant and relevant information. **Concise** communications are to the point and avoid unnecessary elaboration, superfluous detail, redundancy, and wordiness. **Constructive** communications are helpful to the engagement client and the organisation and lead to improvements where needed. **Complete** communications lack nothing that is essential to the target audience and include all significant and relevant information and observations to support recommendations and conclusions. **Timely** communications are opportune and*

expedient, depending on the significance of the issue, allowing management to take appropriate corrective action.

With regard to monitoring progress, Standard 2500 states that the CAE should establish and maintain a system to monitor the disposition of results communicated to management.
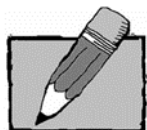
Answer the questions

Question 1

A recommendation in a final engagement communication should address which attribute?

1 Condition.

2 Criteria.

3 Effect.

4 Cause.

Question 2

Follow-up activity is required to ensure that corrective action has taken place. The internal audit function's responsibility to perform follow up activities as required should be defined in the...

1. Internal audit function's written charter.

2. Mission statement of the audit committee.

3. Engagement memorandum issued prior to each internal audit assignment.

4. Purpose statement within the applicable internal audit reports.

Question 1

Recommendations call for action to correct existing conditions or improve operations, and should be based on four attributes. Criteria are the standards, measures, or expectations used in making an evaluation or verification (what should exist). Condition is defined as the factual

evidence that the internal auditor found in the course of his or her audit (what does exist). If actual and expected conditions differ, the cause is the reason for the difference (why the difference exists). The effect is the risk or exposure that the organisation or others encounter because the condition is not the same as the criteria (the impact of the difference). Thus, the recommendation addresses the cause attribute, because it states the necessary corrective action. Therefore option 4 is correct. Option 1 is incorrect because the condition attribute simply describes "what is" to serve as a basis for comparison with given criteria. Option 2 is incorrect because criteria describe "what should be" and are compared with the condition. Option 3 is incorrect because the effect attribute is the impact of the difference between the criteria and the condition.

Question 2

Option 1 is correct since the responsibility for follow-up should be defined in the internal audit charter. Option 2 is incorrect as the internal audit activity's follow-up is not specified in the content of the audit committee mission statement. Option 3 is incorrect as this memo may contain a statement about responsibility for follow up, but such a statement should be based on the wording and authority of the internal audit charter. Option 4 is incorrect as follow up authority and responsibility may be cited in applicable audit reports, but the definition should first be formally included in the internal audit charter.

TOPIC SUMMARY

The systematic phases in the internal auditing process, as well as the different steps involved in each of these phases, were explained in this topic. After studying this topic, you should have an understanding of the audit process, the standards pertaining to each of the phases of the audit process, and the basic activities involved.

Now that you have worked through this topic, are you able to:
• discuss and apply the phases in the internal audit process?

TOPIC 8: INTERNAL AUDIT PROCEDURES AND TOOLS

INTRODUCTION AND PURPOSE OF THE TOPIC

In this topic we identify all the basic auditing aids that an internal auditor employs in the execution of his or her task, and we explain the nature and function of each.

LEARNING OUTCOMES

When you have worked through this topic, you should be able to
• explain the nature and function of the basic aids an internal auditor employs in the conduct of an audit and apply it in practical situations.

CONTENT OF THE TOPIC

This topic is made up of the following learning unit:

Learning unit	Title
8.1	Internal audit procedures and tools

LEARNING UNIT 8.1: INTERNAL AUDIT PROCEDURES AND TOOLS

8.1.1 BACKGROUND

The internal auditing aids that we deal with here are merely auditing tools that the internal auditor uses while carrying out the engagement (audit) procedures. **They are not in themselves audit procedures**. They form an integral part of the total audit, but do not in themselves contribute to the formation of the audit opinion.

The results are produced from the evaluation of the internal controls and the consequent planning of the internal audit by means of the audit programme. The interpretation of the results of the samples and the evidence gathered and included in the audit working papers represent the basis for the development of the audit opinion. On the one hand internal auditing aids provide the transition between the preliminary review and the actual conducting of the internal audit, and on the other hand they serve as the permanent link between the practical audit procedures and the eventual audit opinion as expressed in the internal auditor's report.

In this topic we introduce you to the most important audit aids that an internal auditor uses when conducting an audit. These are:

- Audit marks
- Audit testing/sampling
- Audit working papers
- Audit files

8.1.2 AUDIT MARKS

The internal auditor does not make entries in the books of account; but verifies, or audits transactions that have already been recorded in the books of account. As in the recording process, the internal auditor also experiences a need to utilise a visible sign to signify the completion of a particular audit activity or procedure regarding a specific recorded fact. A distinctive audit mark, or tick, is therefore placed against every examined entry (in front of, after, under, or above) to signify performance of a particular procedure, like routine checking (with its components of casting, transfer, extension, balances carried forward and brought down, et cetera), and vouching and verification. The reason for having different positions for the placing of the marks is simply that one and the same entry may be subjected to more than one procedure or examination function.

While the design and use of audit ticks or marks may, in practice, differ from one organisation to another, it is nevertheless necessary that they should be applied very consistently within one internal audit activity.

Audit ticks have by no means yet been standardised but here are some examples that might be used to indicate specific audit functions:

Casting or additions   ___   underneath the total

Transfer of totals   H   to the left of the total

Postings	:	to the left of the total
Vouching of transactions	#	to the left of the total
Verification of balances	b	to the left of the total

In practice you may encounter either more or fewer of these standard marks or even entirely different symbols.

What you need to remember is that an audit mark signifies completion of an audit task, that is, acceptance of, or satisfaction with, the particular entry. Audit ticks should be used judiciously and sparingly. Make sure you really are satisfied before making the tick. On the other hand, do not forget to make the tick once you are quite satisfied, since unmarked entries represent exceptions requiring further attention. This applies to all types of audits, not just financial audits; for example, when auditing the leave forms as part of the audit of the human resources department, the internal auditor should make a tick next to the signature indicating authorisation of the form after comparing it with the authorised list of signatures. These ticks are normally made in a distinct colour, such as green or purple, so that they can easily be distinguished from the accounting entries. Furthermore, it is good practice to have a legend on the working paper to explain the meaning of each tick mark.

8.1.3 INTERNAL AUDIT TESTING

Audit testing does not mean verifying every entry in the books of account and/or records associated with the audit, but rather the random selection, on a scientific basis, of specific periods, books, records, or types of audit evidence for an audit.

Once the audit objective has been established, the population suggested by the audit objective, for example, the documentation of the whole year's purchases, is determined. Instead of confirming all these transactions, the internal auditor chooses certain transactions at random, but in a scientific manner. These transactions represent the sample, and are subjected to audit procedures.

Test checking (or sampling) is necessitated by the size and volume of the transactions of modern business undertakings, which have made it impossible and unnecessary for an internal auditor to verify every entry. The procedure is, therefore, to make thorough test checks of entries in the records and books of prime entry, and if nothing is found to arouse the internal auditor's suspicions he may assume, without further auditing, that the remaining entries, that is, those not checked, are similarly correct and in order. The use of statistical sampling does not

reduce the need for the internal auditor to use his discretion but provides statistical criteria against which the results of audit tests can be measured. The planning of audit testing is described in the audit programme after the evaluation of the system of internal control and has a direct bearing upon the execution of audit procedures. We will say more about this during the course of your studies (to emphasise the integrated nature of internal auditing) and so, for the present, we merely discuss some theoretical aspects of sampling.

a)   Purpose

Sampling, or testing, (which is merely an audit tool – not a procedure in itself) is applied for the purposes of

- arriving at an audit opinion rapidly and without delay
- arriving at conclusions on whether the population should be accepted or rejected
- assuring that the conclusions regarding the financial and/or other records are reliable and accurate
- on the strength of the theory of probability, using the sampling conclusions as the basis for the reasonableness of the audit opinion

b)   Requirements

Every sample must comply with the following three requirements:

1. It must be **adequate**, that is, it must contain a sufficient number of items to reveal similar results if other samples of the same size are selected from the same population.

2. It must be **representative**, that is, reveal characteristics similar to all the data in the particular population.

3. It must be **stable**, that is, the results of the sample must remain unchanged even if the sample size is increased.

c)   Factors determining nature and scope

The following factors directly determine the nature and scope of audit sampling or testing:

- the effectiveness of the system of internal control the more effective, the smaller the sample.
- materiality of the transactions the more material, the larger the sample.

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- volume of transactions (population size) does not affect the size of the sample

- method of record keeping

- relative risk associated with the transactions

- nature of the evidence

- suggestion of irregularities

- unusual items in the population

8.1.4 INTERNAL AUDIT WORKING PAPERS

It is a professional requirement that internal auditors should work methodically. Just as auditees are expected to produce supporting documentation, internal auditors are expected to keep written records of their procedures and findings.

It is not only dangerous, but also extremely unprofessional for an internal auditor (or his or her assistants) to rely on memory. Of necessity, therefore, internal auditors are continually collecting working papers prepared either by themselves or by their assistants (documents, notes, correspondence, calculations, appendices, etc.) with reference to their audit assignment.

Audit working papers serve in the first place as the link between the internal audit report and the undertaking's records and data, while in the second place they provide an audit manager with a basis for reviewing the fieldwork of junior members of staff. Audit working papers also serve as a guide in the performance of follow-up or subsequent internal audits.

Standard 2330 states the following regarding the recording of information, control and retention of records:

Standard 2330 – Documenting Information

Internal auditors must document relevant information to support the conclusions and

engagement results.

Practice Advisory 2330-1

1.   Internal auditors prepare working papers. Working papers document the information obtained, the analyses made, and the support for the conclusions and engagement results. Internal audit management reviews the prepared working papers.

2.   Engagement working papers generally:

•   Aid in the planning, performance, and review of engagements.

•   Provide the principal support for engagement results.

•   Document whether engagement objectives were achieved.

•   Support the accuracy and completeness of the work performed.

•   Provide a basis for the internal audit activity's quality assurance and improvement program.

•   Facilitate third-party reviews.

3.   The organisation, design, and content of engagement working papers depend on the engagement's nature and objectives and the organisation's needs. Engagement working papers document all aspects of the engagement process from planning to communicating results. The internal audit activity determines the media used to document and store working papers.

4.   The chief audit executive establishes working paper policies for the various types of engagements performed. Standardised engagement working papers, such as questionnaires and audit programs, may improve the engagement's efficiency and facilitate the delegation of engagement work. Engagement working papers may be categorised as permanent or carry-forward engagement files that contain information of continuing importance.

Standard 2330.A1-1:

The chief audit executive must control access to engagement records. The chief audit executive must obtain the approval of senior management and/or legal counsel prior to releasing such records to external parties, as appropriate.

Practice Advisory 2330.A1–1: Control of Engagement Records

1.   Internal audit engagement records include reports, supporting documentation, review notes, and correspondence, regardless of storage media. Engagement records or

working papers are the property of the organisation. The internal audit activity controls engagement working papers and provides access to authorized personnel only.

2. Internal auditors may educate management and the board about access to engagement records by external parties. Policies relating to access to engagement records, handling of access requests, and procedures to be followed when an engagement warrants an investigation, need to be reviewed by the board.

3. Internal audit policies explain who in the organisation is responsible for ensuring the control and security of the activity's records, which internal or external parties can be granted access to engagement records, and how requests for access to those records need to be handled. These policies will vary depending on the nature of the organisation, practices followed in the industry, and access privileges established by law.

4. Management and other members of the organisation may request access to all or specific engagement working papers. Such access may be necessary to substantiate or explain engagement observations and recommendations or for other business purposes. The chief audit executive (CAE) approves these requests.

5. The CAE approves access to engagement working papers by external auditors.

6. There are circumstances where parties outside the organisation, other than external auditors, request access to engagement working papers and reports. Prior to releasing the documentation, the CAE obtains the approval of senior management and/or legal counsel, as appropriate.

7. Potentially, internal audit records that are not specifically protected may be accessed in legal proceedings. Legal requirements vary significantly in different jurisdictions. When there is a specific request for engagement records in relation to a legal proceeding, the CAE works closely with legal counsel in deciding what to provide.

Standard 2330.A2:

The chief audit executive must develop retention requirements for engagement records, regardless of the medium in which each record is stored. These retention requirements must be consistent with the organisation's guidelines and any pertinent regulatory or other requirements.

Practice Advisory 2330.A2–1: Retention of Records

1. Engagement record retention requirements vary among jurisdictions and legal environments.

2. The chief audit executive develops a written retention policy that meets organisational needs and legal requirements of the jurisdictions within which the organisation operates.

3. The record retention policy needs to include appropriate arrangements for the retention of records related to engagements performed by external service providers.

Audit working paper preparation techniques to consider:

- Each engagement working paper should identify the engagement and describe the contents or purpose of the working paper.

- The internal auditor performing the work should sign (or initial) and date each engagement working paper.

- Each engagement working paper should contain an index or reference number.

- Audit verification symbols (tick marks) should be explained.

- Sources of data should be clearly identified.

THE ESSENTIAL ELEMENTS OF A WORKING PAPER	
The following elements should be considered and implemented in order to prepare a working paper of a high professional standard:	
Essential element	Purpose
Decide on a standard format and design a template of this format.	Using a template from the beginning will save time, as it will not be necessary to create a new layout for every new working paper.
Neatness	- It conveys a professional approach to your work. - It avoids confusion and error.
Clarity of meaning	To ensure that the reviewer of the working paper understands the contents and would not need to write a review note saying: "please explain" Use an audit point sheet to note all findings while conducting the audit.

Make full use of the working papers developed in previous and other audits related to the same institution, for example, flowcharts, system descriptions and other data may still be valid.	The use from the beginning of information from previous and other audits related to the same institution will prevent time being wasted on obtaining and documenting the same information.

The following is an example of a basic audit working paper:

Workpaper reference:

Prepared By: (Initials and Date)

Reviewed By: (Initials and Date)

Audit objective

XXXXX

Audit procedures

XXXX

Test workings and results

XXXXX

Conclusion

XXXX

Legends

____: Casting of transactions

#: Vouching of transactions

b: Verification of balances

Referencing of working papers to evidence

Working papers should be referenced to evidence that supports the information documented in the working papers.

Why is it necessary to cross-reference working papers?

- Working papers, together with evidence, make up a "story". If the information is not cross-referenced, it will be impossible to tell the "whole story".
- In addition, it will provide an auditor with a leg to stand on, should the client dispute his or her finding.

Have a look at the example below to see how working papers can be cross-referenced to their supporting documentation (evidence).

Working paper reference: 2100

Test workings and results

An analysis of the logbook maintained by drivers revealed that different kilometre readings were recorded for trips to the same destination. For example, three different drivers who travelled to ABC Hospital recorded the following kilometre readings: 50, 30 and 20 km.

Refer to supporting document **<2100.1>**.

Reference <2100.1>

Logsheet of vehicle: TWR059 GP

Date	Driver	Destination	Starting km	Ending km	Km travelled
2014/12/03	Samuel	ABC Hospital	10503	10533	30
2014/12/05	Sipho	ABC Hospital	10655	10675	20
2014/12/08	Werner	ABC Hospital	10814	10864	50

Working paper 2100 is the working paper prepared by the internal auditor who performed the audit procedure. The supporting documentation (e.g. logsheet – reference 2100.1) is obtained from the auditee, which the auditor keeps a copy as evidence.

8.1.5 AUDIT FILES

There is a difference between permanent working papers (also called the permanent audit file) and current (carry-forward) working papers (the current audit file). The information (data) contained in these two files need not necessarily be kept in separate files, but could instead be filed in separate sections of the same file.

1. Permanent audit file

The permanent audit file should contain information that the internal auditor has to refer to during each audit he or she conducts on an auditee, that is, information which remains relevant beyond the completion of the current audit assignment. The following are some examples of the most important permanent working papers:

- Documents and particulars resulting from the engagement activities and pre-audit investigations, such as audit assignments, formulated needs, documents indicating the scope of the audit (especially restrictions and/or elaborations); documents of a permanent nature or extracts from them, for example policies, procedures and standards, copies of important contracts, particulars of staff, and technical details related to the auditee.

- A written description of the basic system of internal control, together with that of the system of accounting and other record keeping, flow charts and a standard internal control questionnaire related to the auditee.

- Records of accounting and other ratio analysis, tendency determinations, aspects of the previous internal audit report which may have an influence on the following internal audit, for example completed "Comment on findings" forms and statement of risks, together with strengths and weaknesses identified.

- Copies of the completed audit programme of the completed previous internal audit, as well as copies of the final and signed internal audit report.

It is important that the internal auditor's permanent file should be brought up to date periodically, that is, all changes in the undertaking's or business's basic structure, policy or procedures should be noted on existing working papers or alternatively, new working papers should be inserted, depending on the circumstances.

2. Current audit file

The current working papers, or the contents of the current audit file, should only have a bearing upon the current internal audit assignment. They are far more varied, depending upon the nature and circumstances of the auditee, as well as the nature and scope of the audit procedures and findings.

Current audit working papers can only be fully understood and appreciated after having studied the practical audit procedures. These are dealt with in the modules at the third level, and so at this stage we will just give you a list of possible examples:

1. audit queries and replies received (audit correspondence)
2. audit notes, remarks, and/or opinions
3. completed "Comment on findings" forms where applicable
4. schedules of adjustments pursuant to the audit
5. main schedules
6. supporting schedules
7. confirmation certificates (e.g. the bank balance certificate and stock certificates)
8. the completed audit programme and planning documents.

THE LAYOUT OF AN AUDIT FILE

The layout of the audit file should reflect the audit process, that is:

- Determining the audit engagement and overall audit plan
- Planning the audit engagement
- Fieldwork (performing the engagement)
- Audit reporting and follow-up

Answer the following questions

Question 1

Working papers serve the following purpose for the internal auditor:

1. They provide the auditee a place to give responses to audit recommendations.

2. They provide the principal evidential support for the internal auditor's report.

3. They provide a place to summarise overall audit recommendations.

4. They make the audit report more readable by providing a place to append exhibits.

Question 2

Describe what you understand by the term "internal auditing aids" and give two examples thereof.

Question 1

Option 2 is correct. Engagement working papers generally:

- Aid in the planning, performance, and review of engagements.
- **Provide the principal support for engagement results.**
- Document whether engagement objectives were achieved.
- Support the accuracy and completeness of the work performed.
- Provide a basis for the internal audit activity's quality assurance and improvement program.
- Facilitate third-party reviews. (Practice Advisory 2330-1)

Option 1 is incorrect as the final or interim audit reports (not the working papers) normally provide a place for the auditee to give responses to audit recommendations.

Option 3 is incorrect since overall audit recommendations are properly summarised in the audit report. Individual test conclusions are documented in the working papers.

Option 4 is incorrect since the working papers are not an exhibit appended to the audit report

Question 2

Auditing aids are simply auditing instruments that the internal auditor uses while carrying out the audit procedures. They are not in themselves audit procedures. Although they form an integral part of the audit, they merely aid in establishing the content of the audit opinion or conclusion.

Examples:

- Audit marks
- Audit working papers
- Audit testing or sampling
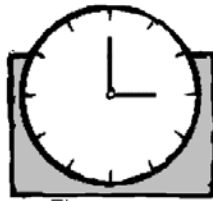
TOPIC SUMMARY

In this topic we discussed a very important aspect of internal auditing, namely the internal audit procedures and aids the internal auditor uses in carrying out his or her task. We discussed the nature and function of the various aids.

Now that you have worked through this topic, are you able to:

- understand the nature and apply the functions of the basic internal auditing procedures and aids which should be used in internal auditing?

PART E: THE RELATIONSHIP BETWEEN INTERNAL AUDITING AND RELATED FUNCTIONS

TOPIC 9: THE RELATIONSHIP BETWEEN INTERNAL AUDITING AND RELATED FUNCTIONS

INTRODUCTION AND PURPOSE OF THE TOPIC

In this topic we explain the relationship between internal auditing and the most important related functions with which the internal auditor comes into contact, namely general management, financial and management accounting, external auditing and information systems.

Because of the special relationship between internal and external auditing, we also pay particular attention to the question of cooperation between internal and external auditors.

 LEARNING OUTCOMES

When you have worked through this topic, you should be able to

- explain the relationship between internal auditing and various other related disciplines, and in that way have a better perspective on the internal auditing environment.

- explain the relationship between internal auditing and general management in an organisation.

- explain the relationship between internal auditing and financial and management accounting in an organisation.

- explain the relationship between internal auditing and external auditing.

- explain the relationship between internal auditing and information systems.

- explain the relationship between internal auditing and the audit committee.

CONTENT OF THE TOPIC

This topic consists of the following learning unit:

Learning unit	Title
9.1	The relationship between internal auditing and related disciplines

LEARNING UNIT 9.1: THE RELATIONSHIP BETWEEN INTERNAL AUDITING AND RELATED DISCIPLINES

9.1.1 THE RELATIONSHIP WITH GENERAL MANAGEMENT

In order to understand the relationship between internal auditing and general management, you need a thorough understanding of the nature of internal auditing and to have knowledge of the principles of business management (see learning unit 2.1)

From your understanding of the nature of internal auditing, the role and function of internal auditing in an organisation should be clear to you. In order to perform his/her duties in a professional manner, the internal auditor should use the principles of efficient management of an organisation as the point of departure and frame of reference when evaluating the efficiency of the management of an organisation.

The achievement of suitable standards of economy, efficiency and effectiveness should be the goal of all managers if they want to discharge their responsibilities toward their organisations to the best of their ability. Not only is the relationship between general management and internal auditing a close one; the two disciplines are to all intents and purposes inseparably intertwined because to a large extent managers and internal auditors are required to think in the same way.

This means that the internal auditor should analyse every normal management function of an organisation into its component elements, and then evaluate them against generally accepted management practices.

While it is the manager's primary responsibility to apply the various management functions continually according to efficient management principles, it is the internal auditor's task to make sure that the manager has discharged his or her responsibilities in the best possible manner, and to assist in improvements where needed. The results of the manager's activities constitute the information that the internal auditor has to evaluate. If the internal auditor discovers any deviations, then he or she must use his or her professional judgement to decide what to do about them in the interest of the organisation. Because of the nature of the work internal auditors do, they have a very close relationship with management, they discuss, recommend and consult with management after each audit to improve and correct any findings.

9.1.2 THE RELATIONSHIP WITH FINANCIAL AND MANAGEMENT ACCOUNTING
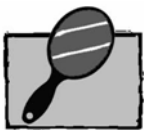
You require a knowledge of the basis of financial and management accounting, that is, of the principles, systems and functions involved.

Accounting information is measurable by criteria such as reliability, adequacy, relevance, understandability, clarity, the ability to be substantiated, neutrality, timeliness, comparability and completeness.

Accounting information must be capable of being substantiated before it can be subjected to audit. Supporting evidence must be available for evaluation in the course of the audit. Because comparison is a necessary component of all evaluations, it must be possible to compare accounting information with the underlying evidence (supporting documentation) to enable the internal auditors to carry out an audit.

Accounting (financial and management) is a creative process and auditing (internal and external) is a critical process.

Accounting is a creative process because

- it establishes the system and process generating the information.
- it summarises the mass of data into understandable and usable information, according to generally accepted principles.

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Auditing (internal and external) on the other hand is a critical process, which by nature is both analytical and exploratory because it

- evaluates the information gathered by the accounting system and process, (both types) and does not, in itself, compile it.
- uses generally accepted accounting principles as a measure/standard for the evaluation of the information.

The complementary nature of auditing (internal and external) and accounting (financial and management)

Auditing and accounting are complementary because accounting, to a great extent, supplies the environment and background for review and evaluation by auditing.

On the other hand, the value of accounting information is enhanced in quality and credibility as a result of the independent, neutral evaluation of that information by the auditor (external and internal).

The auditor/accountant

To be able to evaluate (audit), auditors must know the techniques, procedures, principles and practices of accounting. They must firstly have the knowledge and skills of an accountant before they can act as auditors, but the accountant/management accountant does not necessarily have to possess the knowledge and skills of an auditor.

Because the objectivity of the auditor's opinion (external as well as internal) is of the utmost importance, auditors should not audit information compiled by them.

In the case of management accounting (where the information is compiled by management for decision-making purposes) the interested parties are fewer and there is less chance of a conflict of interests. The conflict of interests is confined to internal interests within the enterprises. The users are not removed from the source of information either, as is the case with external users (e.g. shareholders and creditors).

As a result of these differences, management's auditing requirements are different from those of the external users of the information. Negligence, dishonesty and error remain a possibility, however, so that a need for auditing, both internal and external, is also evident in the case of management accounting.

In the case of management accounting, internal auditing satisfies the need for credibility and control. Internal auditing is, therefore, a necessity in and around the accounting core, which serves as a starting point and basis for all the sub disciplines of accounting.

9.1.3 THE RELATIONSHIP WITH EXTERNAL AUDITING
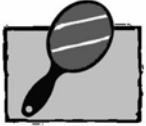
We previously mentioned that auditing, in a broad context, is a critical review/evaluation process to which information is subjected with the aim of reporting. Reporting is the main objective of both external and internal auditing.

In the case of **internal auditing**, the critical review or evaluation is executed with the aim of reporting to interested parties within the organisation. The review and reporting would **cover any matter that could assist members of the organisation in the effective discharge of their responsibilities**.

In the case of **external auditing**, the critical review/evaluation is executed with the aim of reporting to interested parties both externally and internally. The review and reporting deals mainly with the **expression of an opinion** pertaining to the **fairness** or otherwise of the **financial statements** rendered, the state of affairs of the business and the results of the client's business operations or activities.

Although internal auditing and external auditing have numerous interests and functions in common, and use the same tools and techniques, their underlying objectives, approaches and responsibilities differ in the following respects:

- External auditors express an opinion on the acceptability of the client's financial statements, while it is not normally expected of the internal auditor to express an opinion to third parties.

- External auditors may rely on the reviews of internal auditors as an aid in performing their own audits.

- External auditors are responsible for evaluating the system of internal control as it relates to the financial statements to determine whether they can rely upon it. Management is responsible for implementing and maintaining the system of internal control. The internal audit activity forms part of the complete system of internal control and functions as a detective control, but does not itself form a direct link in the process of control. Internal auditors will extend their

review of controls to the areas not completely covered in the normal course of events by the external auditor, as well as to areas that fall outside the external auditor's normal area of responsibility.

Refer to Topic 1, Learning unit 1.1, to refresh your knowledge on the key differences between external and internal auditing.

Cooperation and coordination between the internal and external auditors to reflect the interrelationship between the two disciplines

Although this topic deals with the relationship between internal auditing and related functions, the relationship and cooperation between internal and external auditors is highly relevant to our discussion.

Cooperation with external auditors constitutes an important part of the activities of internal auditors. You, therefore, need to be fully informed about the form this cooperation takes.

External auditors are under increasing pressure to fulfil their duties with greater efficiency, because of demands by organisations for lower audit fees, prompter completion of audits and because of competition within the profession. They must, therefore, strive to provide better service at a lower cost. This can only be achieved by making proper use of the audit aids at their disposal. One such aid is the internal auditor.

The internal audit activity serves primarily as a strengthening factor in the system of internal control of an undertaking. Management places an obligation on the internal auditor to execute his or her duties effectively within the limits of his or her budget. The external auditor's main objective when examining the system of internal control is to test its compliance with presumed control measures, and to determine the extent to which it can be relied on to produce reliable financial information. The external and internal auditor can, therefore, be of great assistance to one another, as their conclusions regarding the effectiveness of the system of internal control are directly related to both their responsibilities in the area of internal control.

Interaction between the two groups evolved from the possibility of utilising one another's services and abilities as an aid in achieving their individual audit objectives. The effectiveness of this arrangement naturally depends on the maintenance of a strong professional relationship.

Mutual confidence

Because both groups share certain objectives and certain areas of work, it is in both their interests to promote a cooperative relationship in order to render a more cost-effective and efficient service.

In their attempts to promote better relations, the parties must bear the following in mind:

1. Their interaction must have as its object the optimum utilisation of audit aids.

2. The role and responsibilities of both groups of auditors differ substantially, because internal auditors report to management and external auditors to the owners (shareholders).

3. In terms of the internal auditor's responsibility to management he or she may not be allowed to discuss certain matters with the external auditors.

4. The external auditor may decide not to disclose certain suspicious or confidential matters to the internal auditor.

Right of access to records

External auditors have the right of access to all documents of a company (including the internal auditor's records). They are also entitled to require from the personnel of a company (including the internal auditor) such information and explanations as they deem necessary for the performance of their duties.

The internal auditor, however, does not have the same right of access to the records of the external auditor, or any right to obtain assistance from the external auditor in the performance of his or her duties. Although there should be access to each other's' audit programs and working papers for the determination of the degree of reliance on the others' work. Access, on both parts, must be carried with respect for confidentiality of the working papers.

Nature and advantages of a good relationship

The relationship between the external auditor and the internal auditor must develop in such a way as to promote the interaction necessary to ensure economical auditing. At the same time, this relationship must aim to provide an efficient service to the undertaking.

Such a relationship is possible only if there is agreement between the external and internal auditors with regard to their mutual objectives and those matters where their interests overlap. The following can be regarded as areas in which interests would overlap:

1. The effectiveness of risk management and the system of internal control

2. The effectiveness of the undertaking

3. The completeness and accuracy of the financial information

A good relationship between the external and internal auditor will have the following three advantages for the parties and the undertaking concerned:

1. An opportunity is created for interaction that is advantageous to the external auditor, the internal auditor and the undertaking, because time and money are saved in this way.

2. The external auditor can reduce the extent of his or her audit procedures and audit tests, if he or she intends to rely on the work of the internal auditor.

3. The internal auditor has the assurance that an independent person is evaluating the internal audit activity, and that he will provide objective recommendations. This review by the external auditor enables the internal auditor to evaluate the results obtained in the past by the internal audit activity, and the review can also serve as a guideline for future action and improvements.

Factors which can give rise to a poor relationship

The following factors could give rise to a poor relationship:

1. Lack of initiative on the part of both parties.

2. Failure on the part of the external auditor to acknowledge the role and experience of the internal auditor.

3. The opinion of certain external auditors that internal auditors are not capable and well trained.

4. Uncertainty regarding the extent to which external auditors can rely on the work of internal auditors.

5. The policy of using internal audit personnel in assisting the external auditor can disrupt the smooth implementation of the internal audit department's own work programme, which is a continuous, risk-based programme, not aimed at year-end audits. This could cause the rescheduling of the internal auditor's planning in order to make personnel available to the external auditor.

6. Internal auditors are perhaps not particularly willing to help external auditors. They may feel that internal auditors are being used as "second class" auditors performing work, outside their actual work environment, which the external auditor does not want to do.

Mutual trust

The degree of trust that the external auditor is prepared to place in an undertaking's system of internal control depends on how effective he or she finds that system to be.

The internal audit activity is a vital part of the system of internal control, and is a valuable aid in ensuring that the system and procedures are efficiently maintained.

Owing to the fact that the internal audit activity is part of the overall system of internal control, the external auditor must evaluate the effectiveness of the internal audit department. It is necessary for the external auditor to determine whether he or she can rely on the work of the internal audit activity and its personnel in order to reduce his or her audit tests.

The external auditor may decide to rely on the work of the internal auditor and in that way reduce his or her own tests, or to make use of the internal auditor's services to perform certain audit duties on his or her behalf. However, where the external auditor relies on the internal auditor, he or she must be careful not to make use of the internal auditor for activities performed or controlled by the internal auditor personally. This is necessary to ensure that the internal auditor's objectivity will not be affected.

The nature of the trust

The reliance which the external auditor may place on the work of the internal auditor can take two forms:

First, the external auditor may rely on the work performed by the internal auditor in the normal course of his or her duties. By evaluating and testing the risk management process and the system of internal control and by reporting to management, the internal auditor increases the reliability and accuracy of financial accountability. The internal auditor's involvement in risk

management and the system of internal control will normally influence the scope and nature of the tests and evaluations performed by the external auditor. The greater the confidence that the external auditor places in the internal auditor's evaluation, the more attention can be devoted to reviews in those areas that the internal auditors identified as problem areas.

Second, the external auditor may, at the request of the internal auditors, place reliance on audit work performed by the internal auditors.

The first-mentioned tests are broader in scope than the second group. They are designed and performed by the internal auditor as part of his own objectives and routine work, which are compatible with the objectives of the external auditor. Tests of the second kind are more limited in scope, because only specific tests are performed (as prescribed by the external auditor for specific purposes). When the external auditor plans to rely on the work of the internal audit activity, it is important that he or she should take the annual plan or work programme of the internal audit department into consideration, and this is usually scheduled on a yearly basis. The nature and scope of his or her requests and of his or her own tests should be adapted accordingly, if necessary.

Problems that may arise as a result of this can be overcome if the external auditor and the internal auditor coordinate their work programmes early in the year. Where necessary, cooperative work plans should be worked out in order to prevent unnecessary interference and/or work disruption in the internal audit department.

Factors which influence trust

The external auditor should consider the following criteria before relying on the work of the internal auditor:

1. The organisational independence (Standard 1110) and level of reporting of the internal auditor. In other words, does the internal audit department have enough authority to perform its audits as it deems fit?

2. Does the internal audit activity enjoy the support of top management? In other words, is the quality of the internal audit reports such that management will act on them?

3. Does the internal audit activity exercise due professional care (Standard 1220) during the planning, performance and supervision of their duties? In other words, do sufficient audit manuals, internal audit plans, supervision, quality control, reporting and follow-up procedures exist?

4. Do the internal audit personnel possess sufficient technical competence and knowledge of the concern's business activities and procedures and do they participate in continued training programmes?

Criteria (1) and (2) can be considered to be factors supporting objectivity, whereas criteria (3) and (4) are indicative of the proficiency of the internal audit activity. Independence is the determining factor for objectivity, and technical competence is the determining factor for proficiency.

Limitations and dangers in connection with the work of the internal auditor

The results of the external auditor's evaluation of the efficiency of the internal audit activity, the factors concerning the materiality of the areas or items that are to be audited, the audit risk involved and the level of judgement required of him or her will all directly influence the degree to which he or she will make use of the internal auditors' services in his or her examinations. However, before relying on the work of the internal auditors, the external auditor should consider certain restrictions and dangers, such as the following:

These restrictions and dangers can be summarised as follows:

1. The employer/employee relationship places restrictions on the objectivity and independence of the internal auditors, because they are responsible to management, which determines the objectives and scope of the internal audit activity in the organisation.

2. External auditors are concerned primarily with the fairness of the financial statements, and their tests must be performed in accordance with generally accepted auditing standards. Internal auditors, on the other hand, are concerned primarily with the wider concept of operational or managerial efficiency.

3. The external auditor cannot delegate responsibility for his or her professional opinion. He or she must not rely excessively on the internal audit activity, regardless of its quality and scope. If the internal auditor becomes too closely involved, the external auditor's insight and judgement could be detrimentally affected.

4. The decision to make use of internal audit time in order to reduce external audit time loses its value if the external auditor has to perform additional tasks to determine whether his or her reliance on the internal auditor is justifiable. Audit efficiency is not fully utilised if

the external auditor has to test a substantial part of the work performed by the internal audit activity in key areas.

5. The reliance placed on the work of internal auditors by external auditors has not yet attracted the attention of the courts. As no definite standards have been developed as yet to regulate the relationship between the external auditor and the internal auditor, it can be assumed that the onus will rest on the external auditor to prove

    a) the extent to which he or she relied on the work of the internal auditors; and

    b) that he or she had exercised due care.

Similar risks are likely to be encountered under South African conditions. Therefore, it is important that the public auditing profession in South Africa should formulate standards to serve as guidelines for the external auditor in his or her relationship with the internal auditor and the utilisation of the latter's work.

Mutual cooperation and coordination

The International Institute of Internal Auditors specifically requires the chief audit executive to coordinate the work of the internal and external auditors so as to ensure sufficient audit coverage and keep duplication to a minimum.

Standard 2050 – Coordination

The chief audit executive should share information and coordinate activities with other internal and external providers of assurance and consulting services to ensure proper coverage and minimise duplication of efforts.

1. Oversight of the work of external auditors, including coordination with the internal audit activity, is the responsibility of the board. Coordination of internal and external audit work is the responsibility of the chief audit executive (CAE). The CAE obtains the support of the board to coordinate audit work effectively.

2. Organisations may use the work of external auditors to provide assurance related to activities within the scope of internal auditing. In these cases, the CAE takes the steps necessary to understand the work performed by the external auditors, including:

- The nature, extent, and timing of work planned by external auditors, to be satisfied that the external auditors' planned work, in conjunction with the internal auditors' planned work, satisfies the requirements of Standard 2100.

- The external auditor's assessment of risk and materiality.

- The external auditors' techniques, methods, and terminology to enable the CAE to (1) coordinate internal and external auditing work; (2) evaluate, for purposes of reliance, the external auditors' work; and (3) communicate effectively with external auditors.

- Access to the external auditors' programs and working papers, to be satisfied that the external auditors' work can be relied upon for internal audit purposes. Internal auditors are responsible for respecting the confidentiality of those programs and working papers.

3. The external auditor may rely on the work of the internal audit activity in performing their work. In this case, the CAE needs to provide sufficient information to enable external auditors to understand the internal auditors' techniques, methods, and terminology to facilitate reliance by external auditors on work performed. Access to the internal auditors' programs and working papers is provided to external auditors in order for external auditors to be satisfied as to the acceptability for external audit purposes of relying on the internal auditors' work.

4. It may be efficient for internal and external auditors to use similar techniques, methods, and terminology to coordinate their work effectively and to rely on the work of one another.

5. Planned audit activities of internal and external auditors need to be discussed to ensure that audit coverage is coordinated and duplicate efforts are minimised where possible. Sufficient meetings are to be scheduled during the audit process to ensure coordination of audit work and efficient and timely completion of audit activities, and to determine whether observations and recommendations from work performed to date require that the scope of planned work be adjusted.

6. The internal audit activity's final communications, management's responses to those communications, and subsequent follow-up reviews are to be made available to external auditors. These communications assist external auditors in determining and adjusting the scope and timing of their work. In addition, internal auditors need access to the external

auditors' presentation materials and management letters. Matters discussed in presentation materials and included in management letters need to be understood by the CAE and used as input to internal auditors in planning the areas to emphasise in future internal audit work. After review of management letters and initiation of any needed corrective action by appropriate members of senior management and the board, the CAE ensures that appropriate follow-up and corrective actions have been taken.

7.   The CAE is responsible for regular evaluations of the coordination between internal and external auditors. Such evaluations may also include assessments of the overall efficiency and effectiveness of internal and external audit activities, including aggregate audit cost. The CAE communicates the results of these evaluations to senior management and the board, including relevant comments about the performance of external auditors.

Nature and extent of cooperation
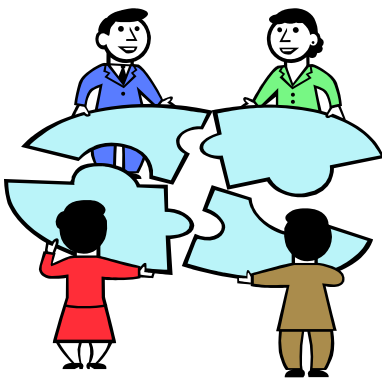
Internal and external auditors can complement each other in many different ways. The internal auditors can place the external auditor in a position where the latter can use and rely on the work of the internal audit department, since much of the work performed by the internal audit department is useful to the external auditor in his or her audit of the client's financial information. The external auditor can assess the extent to which the internal audit department is complying with the standards prescribed by the International Institute of Internal Auditors and propose additional procedures if necessary.

The following supportive actions could contribute to productive cooperation and coordination between the external and internal auditors:

1.   A **common audit methodology.** Both groups adopt a common approach to audit work. For example, both groups of auditors would use similar auditing procedures and standardised audit working papers in the performance of the financial audit process.

2. **Joint training programmes.** These are useful only if they occur selectively and deal with matters of mutual interest (e.g. general audit techniques, flowcharting, statistical sampling, interviewing skills)

3. **Joint planning of audit work.** Planning could be undertaken by the two groups with each other's audit plans at their disposal, and joint audit plans could be developed. The reciprocal availability of audit plans is not all that important, however, as the external auditor needs to maintain the element of surprise and objectivity, which are in keeping with external auditing. It is, however, necessary to develop a joint audit plan in respect of those areas in which the external auditor intends to use the services of the internal auditor.

4. **Direct assistance with each other's projects**. An exchange of resources creates further cooperation as the available audit skills base is added to as and when required. It is doubtful, however, whether this proposal will receive sufficient support. Furthermore, it is doubtful whether internal and external auditors would agree to work under each other's authority.

5. **Exchange of audit reports** on matters of mutual interest, and the follow-up on suggestions and recommendations by the other party**.**

6. **Direct support in that working papers are at each other's disposal.** It is doubtful, however, whether this proposal will receive sufficient support. External auditors, specifically, will not be inclined to release their working papers in order to assist the internal auditors, because of considerations of confidentiality.

7. **Periodic meetings** where aspects of mutual interest regarding their audit responsibilities are discussed.

8. **A professional attitude** toward each other and mutual respect for each other's professional responsibilities.

9. **The evaluation by internal and external auditors of the effectiveness of each other's work and reporting on this to management.** External auditors have an interest in the efficiency with which the internal audit activity is performed, because it falls within the normal scope of their responsibility to report to management on the efficiency and effectiveness of the internal control system as a whole. Although internal auditors do not have a similar responsibility, a sound and objective evaluation of each other's efficiency may serve as an incentive to improve the quality of both the internal and the external audit activities.

(Adapted from Spencer Pickett, KH, *The internal auditing handbook* (2010:p96-97))

Advantages of cooperation

Good cooperation between the external and internal auditors has the following advantages:

1. Reports issued by the internal and external auditors and schedules of tests performed by them support the quality of the internal control and the extent to which set procedures were followed.

2. The internal auditor's working documents may include descriptions and assessments of the internal control system, which could prove to be very useful to the external auditor when he or she needs to determine which areas are to be examined.

3. If the internal auditor renders assistance with the examination of the day-to-day affairs, the external auditor will be able to concentrate on areas of greater importance.

4. As a result of the greater inside knowledge and experience of the internal audit group, the external auditors will be able to gain more knowledge of the business activities and operations of their client.

5. The assistance given by the internal audit department could have a material effect on reducing the external audit fee, and could mean considerable savings for the undertaking. The degree of saving will be directly related to the experience and effectiveness of the internal audit group, and the materiality of the duties they perform.

6. Good cooperation and coordination promote and improve relationships between external and internal auditors and the client.

7. Good cooperation can enhance the status of the internal audit activity.

Disadvantages of cooperation

Despite the advantages listed above, there are also certain disadvantages and problems associated with close cooperation and interdependence between the internal and external auditors. These are:

1. Cost-saving must take into consideration the actual cost of both groups of auditors. It is not always possible to calculate the actual cost saving because the allocation of internal and external audit time is not normally done on the same basis.

2. A decision to alter the audit work plan of the internal audit activity must be taken, bearing in mind the work that would otherwise be performed by the internal audit activity. The planning of the work of the internal audit activity is normally associated with the usual business operations of the undertaking in relation to the current year and not with the year-end work of the external auditor. An unplanned re-scheduling of the internal auditor's work plan might result in a delay in the normal flow of operations of the internal

audit activity (resulting in additional costs for the undertaking).

3. The use of the internal auditors to perform certain duties for the external auditors may cause resentment among the internal audit personnel. They may feel that they are being prevented from performing their actual work, and that they are being used as "second class" auditors to perform work in which the external auditor does not want to be involved.

9.1.4 THE RELATIONSHIP WITH INFORMATION SYSTEMS

The study of information systems is an independent discipline with its own theoretical basis, principles of design and practical application. Information systems are an indispensable element of effective management in any organisation or body. They have a wider reach than management information systems. Information systems gather and process information on all the activities of an organisation, whereas management information systems include mainly routine information for management activities such as planning, control and decision-making and are, therefore, simply a subdivision of information systems. Well-developed information systems include various other components, which we will not deal with here.

Owing to advancements in electronic technology, highly sophisticated information systems are available today; they are an extremely important management aid in a highly sophisticated and competitive economy. If the management of an organisation utilises this resource effectively, it gives that organisation a competitive advantage. Present-day information systems have been made possible by technological developments, and the internal auditor has an ideal opportunity to use this technology to carry out his or her task more effectively.

The technological developments that have taken place have created an important and extensive additional field of expertise for internal auditors, who now require considerable technological knowledge and competence. Internal auditors have to ensure that the available

technology is effectively utilised in the design of the information system and the accompanying controls, which are introduced to ensure the effectiveness of the system.

9.1.5 THE RELATIONSHIP WITH THE AUDIT COMMITTEE

Refer to learning unit 2.2 for background information about the audit committee.

In order to enhance a good relationship between the audit committee and the internal audit activity, the following practices should be followed.

- The chief audit executive should have the following dual-reporting responsibilities:
    - ❖ functionally to the audit committee, and
    - ❖ administratively to the chief executive officer.

- The chief audit executive should have ready access to the audit committee.
- The chief audit executive should have direct and regular communication with the audit committee.
- The chief audit executive should attend audit committee meetings.
- The chief audit executive should regularly meet privately with the audit committee (without management's representatives in attendance).
- The audit committee should approve the appointment or removal of the chief audit executive.
- The audit committee should be advised by the chief audit executive concerning his or her relationship with the external auditors (and on how the internal and external audits are progressing).

It is important that you understand the type of communication or relationship that should be established between the chief audit executive and the audit committee, assuming that the chief audit executive still reports to the chief executive officer.

Functions usually performed by audit committees

In order to understand the relationship of the internal auditor with the audit committee of an organisation, you need to study the function of an audit committee. Audit committees, as a subcommittee of the Board of Directors, should have their own audit committee charter. Investigating the content of the charter gives a good summary of the responsibilities and characteristics of audit committees:

Sample Audit Committee Charter

The following sample charter captures many of the best practices used today. Of course, no sample charter encompasses all activities that might be appropriate to a particular audit committee, nor will all activities identified in a sample charter be relevant to every committee. Accordingly, this charter must be tailored to each committee's needs and governing rules.

Please note that this audit committee charter is for illustrative purposes only, and we won't ask you to draft a charter in the examination. However, you **should be able to explain the basic responsibilities of the audit committee** as set out in a charter like the one below.

Audit Committee Charter

PURPOSE
To assist the board of directors in fulfilling its oversight responsibilities for the financial reporting process, the system of internal control, the audit process, and the company's process for monitoring compliance with laws and regulations and the code of conduct.

AUTHORITY
The audit committee has authority to conduct or authorise investigations into any matters within its scope of responsibility. It is empowered to:

- Appoint, compensate, and oversee the work of any registered public accounting firm employed by the organisation.

- Resolve any disagreements between management and the auditor regarding financial reporting.

- Pre-approve all auditing and non-audit services.

- Retain independent counsel, accountants, or others to advise the committee or assist in the conduct of an investigation.

- Seek any information it requires from employees-all of whom are directed to cooperate with the committee's requests-or external parties.

- Meet with company officers, external auditors, or outside counsel, as necessary.

COMPOSITION

The audit committee will consist of at least three and no more than six members of the board of directors. The board or its nominating committee will appoint committee members and the committee chair.

Each committee member will be both independent and financially literate. At least one member shall be designated as the "financial expert," as defined by applicable legislation and regulation.

MEETINGS

The committee will meet at least four times a year, with authority to convene additional meetings, as circumstances require. All committee members are expected to attend each meeting, in person or via tele- or video-conference. The committee will invite members of management, auditors or others to attend meetings and provide pertinent information, as necessary. It will hold private meetings with auditors (see below) and executive sessions. Meeting agendas will be prepared and provided in advance to members, along with appropriate briefing materials. Minutes will be prepared.

RESPONSIBILITIES
The committee will carry out the following responsibilities:

Financial Statements

- Review significant accounting and reporting issues, including complex or unusual transactions and highly judgmental areas, and recent professional and regulatory pronouncements, and understand their impact on the financial statements.

- Review with management and the external auditors the results of the audit, including any difficulties encountered.

- Review the annual financial statements, and consider whether they are complete, consistent with information known to committee members, and reflect appropriate accounting principles.

- Review other sections of the annual report and related regulatory filings before release and consider the accuracy and completeness of the information.

- Review with management and the external auditors all matters required to be communicated to the committee under generally accepted auditing *Standards.*

- Understand how management develops interim financial information, and the nature and extent of internal and external auditor involvement.

- Review interim financial reports with management and the external auditors before filing with regulators, and consider whether they are complete and consistent with the information known to committee members.

Internal Control

- Consider the effectiveness of the company's internal control system, including information technology security and control.

- Understand the scope of internal and external auditors' review of internal control over financial reporting, and obtain reports on significant findings and recommendations, together with management's responses.

Internal Audit

- Approve the internal audit charter.

- Approve decisions regarding the appointment and removal of the chief audit executive. Ensure there are no unjustified restrictions or limitations, and review and concur in the appointment, replacement, or dismissal of the chief audit executive.

- Approve the annual audit plan and all major changes to the plan. Review the internal audit activity's performance relative to its plan.

- Review with the chief audit executive the internal audit budget, resource plan, activities, and organisational structure of the internal audit function.

- At least once per year, review the performance of the chief audit executive and concur with the annual compensation and salary adjustment.

- Review the effectiveness of the internal audit function, including conformance with The Institute of Internal Auditors' the Definition of Internal Auditing, Code of Ethics and the *International Standards for Professional Practice of Internal Auditing.*

- On a regular basis, meet separately with the chief audit executive to discuss any matters that the committee or internal audit believes should be discussed privately.

External Audit

- Review the external auditors' proposed audit scope and approach, including coordination of audit effort with internal audit.

- Review the performance of the external auditors, and exercise final approval on the appointment or discharge of the auditors.

- Review and confirm the independence of the external auditors by obtaining statements from the auditors on relationships between the auditors and the company, including non-audit services, and discussing the relationships with the auditors.

- On a regular basis, meet separately with the external auditors to discuss any matters that the committee or auditors believe should be discussed privately.

Compliance

- Review the effectiveness of the system for monitoring compliance with laws and regulations and the results of management's investigation and follow-up (including disciplinary action) of any instances of noncompliance.

- Review the findings of any examinations by regulatory agencies, and any auditor observations.

- Review the process for communicating the code of conduct to company personnel, and for monitoring compliance therewith.

- Obtain regular updates from management and company legal counsel regarding compliance matters.

Reporting Responsibilities

- Regularly report to the board of directors about committee activities, issues, and related recommendations.

- Provide an open avenue of communication between internal audit, the external auditors, and the board of directors.

- Report annually to the shareholders, describing the committee's composition, responsibilities and how they were discharged, and any other information required by rule, including approval of non-audit services.

- Review any other reports the company issues that relate to committee responsibilities.

Other Responsibilities

- Perform other activities related to this charter as requested by the board of directors.

- Institute and oversee special investigations as needed.

- Review and assess the adequacy of the committee charter annually, requesting board approval for proposed changes, and ensure appropriate disclosure as may be required by law or regulation.

- Confirm annually that all responsibilities outlined in this charter have been carried out.

- Evaluate the committee's and individual members' performance on a regular basis.

Reference: The Institute of Internal Auditors' website at https://na.theiia.org/standards-guidance

Answer the following questions

Question 1

Internal and external audit work should be coordinated to ensure adequate audit coverage and to eliminate unnecessary duplication of effort. Which one of the following alternatives involves the coordination of audit effort?

1.   Exchange of audit reports on matters of mutual interest.

2.   Periodic meetings to discuss general economic growth and market direction.

3.   Common understanding of the respective audit reports and presentations to management.

4.   Dual use of audit clerks for audit activities.

Question 2

The economic recession and subsequent retrenchments had a significant effect on the financial performance of a South African company and on the morale of its staff. Because management suspected employee fraud, they requested the internal audit team to conduct a compliance audit on procurement and tendering processes and to evaluate the effectiveness of controls. As leader of this team, you were asked to present the findings of the audit to the board of directors and the audit committee at a meeting specifically arranged for this purpose. The meeting was postponed several times because the members of the audit committee were not able to attend.

Explain why it is important to include the audit committee in the meeting **and** mention relevant functions that the audit committee members are required to perform in relation to the internal audit activity.

Question 1

The question explains a benefit of coordination between internal audit and external audit. You are required to select the option that best describes a coordinated effort between internal and external audit.

Option 1 is correct because the exchange of audit reports assists in the co-ordination of work between internal and external Audit.

Option 2 is incorrect as discussions of general economic growth and market direction are not a supportive action and will not benefit either party.

Option 3 is incorrect because presentations to management is not a supportive action and does not provide a benefit to either party.
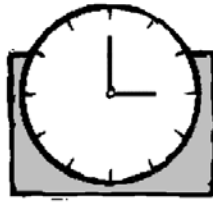
Option 4 is incorrect because dual use of audit trainees is not a supportive action and will not benefit either party.

Question 2

Reporting to the audit committee gives the internal audit activity a high degree of independence and accessibility because it is reporting to a body with more authority than top executive management.

Functions performed by the audit committee in relation to the internal audit activity

- Approve the internal audit charter.

- Approve decisions regarding the appointment and removal of the chief audit executive. Ensure there are no unjustified restrictions or limitations, and review and concur in the appointment, replacement, or dismissal of the chief audit executive.

- Approve the annual audit plan and all major changes to the plan. Review the internal audit activity's performance relative to its plan.

- Review with the chief audit executive the internal audit budget, resource plan, activities, and organisational structure of the internal audit function.

- At least once per year, review the performance of the chief audit executive and concur with the annual compensation and salary adjustment.

- Review the effectiveness of the internal audit function, including conformance with The Institute of Internal Auditors' the Definition of Internal Auditing, Code of Ethics and the *International Standards for Professional Practice of Internal Auditing.*

- On a regular basis, meet separately with the chief audit executive to discuss any matters that the committee or internal audit believes should be discussed privately

TOPIC SUMMARY

Because of its nature and functions, internal auditing does not take place in a vacuum. In order to carry out his or her function successfully, the internal auditor requires knowledge of a variety of important related functions. In this topic we discussed the relationship between five of the most important functions related to internal auditing. The part that each of these functions plays in internal auditing was also explained.

Now that you have worked through this topic, are you able to:
• explain the relationship between internal auditing and various other related disciplines, and in that way have a better perspective on the internal auditing environment?
• explain the relationship between internal auditing and general management in an organisation?
• explain the relationship between internal auditing and financial and management accounting in an organisation?
• explain the relationship between internal auditing and external auditing?
• explain the relationship between internal auditing and information systems?
• explain the relationship between internal auditing and the audit committee?

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