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WHY RISK-BASED AUDIT PLANNING?

> The chief audit executive should establish risk-based plans to determine the priorities of the internal audit activity, consistent with the organization's goals.
>
> —IIA Standard 2010

INTRODUCTION

Internal auditing has grown tremendously over the years to reflect its new high-profile position in most large organizations. It has shifted from back-office checking teams to become an important corporate resource. The focus on professionalism and objectivity has driven the new-look auditor toward high-impact work that can really make a difference. *Risk-Based Audit Planning* is the second book in the Auditing New Horizons book series. The first book set out a framework for audit's role in ERM, while this second book describes how to put these aspirations into action.

The practical focus of this book has necessitated a greater use of case studies and checklists. Note that the same format of building purpose-made models for each chapter as exists in *Auditing Risk Management* is applied and this format will apply to all the books in the Auditing New Horizons series. *Risk-Based Audit Planning* draws on a number of important sources of information and guidance. First and foremost is the Institute of Internal Auditor's (IIA) professional practices framework that includes research, position papers, and noted textbooks as well as the standards, code of ethics, practice advisories, IIA publications, and pronouncements. This second book becomes more detailed as we consider how the auditor prepares the actual strategy for delivering audit's role. We will be discussing the way plans are prepared by the auditor to ensure that audit's role is properly discharged in a professional manner.

The growing demands for better accountability from all types of organizations in both the public and private sectors has led to great pressures on the internal and external auditors to perform. The starting place, assuming there is a professional audit shop in place, is to prepare a well-appointed strategy that supports first-class audit plans. There is little scope for delivering the goods, unless and until there has been enough time and effort spent on working out where to focus this effort. There are many documented cases where auditors have failed in this respect, not the least being the WorldCom case where at the bankruptcy hearing it was suggested that:

> Of concern is the lack of any effective participation by the Audit Committee in reviewing the adequacy of the annual internal audit plan, with the Audit Committee appearing to have approved the final plan as a formality. Based upon requests of Management, other audits, not part of the Audit Committee-approved plan, were added while some audits originally scheduled were not completed. At most, the Audit Committee was advised of such changes after the fact. Under such circumstances, senior management could influence the focus of the Internal Audit Department away from sensitive areas without the oversight that the Audit Committee would normally be expected to provide.[1]

This criticism of the internal audit approach to planning audit work may well cast a shadow over the future of the internal audit process. There is now less room for failure in terms of developing and implementing an effective process for assigning the right audit resources to the right work. Risk-based audit planning has come to the rescue as a way of targeting high-risk areas and helping the auditors achieve maximum value for their efforts. Before launching our first model, we need to outline the formal definition of *internal auditing* from the IIA:

> Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.[2]

As is clear from this definition, the auditor has a crucial role to play in helping the organization meet the growing demands for better governance, which incorporates the need for effective risk management and reliable controls. Risk drives the entire economy and also public services. Companies face the risk of collapse, public services risk failing to meet their customers' needs, while not-for-profit organizations risk not achieving their various mandates. Meanwhile, audit faces the risk of expressing an inappropriate opinion owing to:

- Performing the wrong audit
- Employing the wrong audit approach
- Using the wrong staff
- Breaching professional standards
- Performing work at the wrong time
- Issuing the wrong reports and delivering the wrong underlying assurances

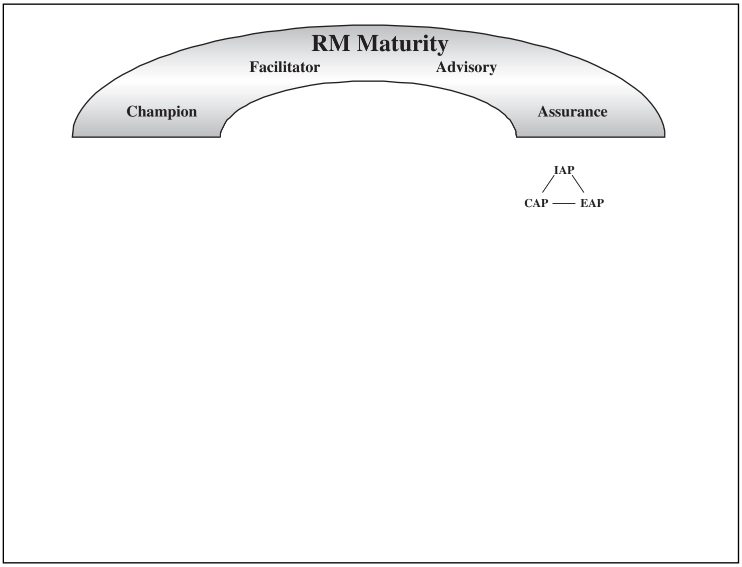
These risks become huge when set against the background of the new corporate context driven by Sarbanes-Oxley (SOX) and the demands placed on boards and audit committees for full and accurate disclosures on governance arrangements and financial controls. Audit teams are being asked to rally round the "big issue" of how to keep the executive team safe by helping it manage the risk of falling foul of SOX or whatever regulatory rules impact the sector in question. This chapter looks at the overall concept of audit planning and reinforces the important value that derives from well-researched plans and a robust audit-planning process. Risk-based audit planning may be seen as an approach to audit work that focuses on strategic, regulatory, financial, and business risks that confront an organization, and which uses these risks to steer the audit process in a way that maximizes the impact of audit's assurance and consulting work. Planning takes time and effort and the model that is developed in this chapter seeks to address the question: "Why bother to spend a great deal of time planning?"

RISK-BASED AUDIT-PLANNING MODEL: PHASE ONE

Our first model appears in Figure 1.1.

Each aspect of the model is described in the following paragraphs.

Figure 1.1 Risk-Based Audit-Planning Model: Phase One



Champion

The model builds on the first book in the Auditing New Horizons series, *Auditing the Risk Management Process*. It does this by using the risk management maturity model that starts on the left (i.e., risk immaturity) and moves through to full risk maturity on the right. Meanwhile, audit's role in the risk management process moves through various stages that are described in our first model in Figure 1.1, starting with a consulting role as risk champions. Organizations that have not made much progress in establishing an effective risk management process are asking their audit teams to help kick-start the task. In this scenario, annual audit plans have been torn up and replaced by a wholesale effort to resource the risk champion role. The IIA has studied this dilemma and considered the impact of SOX on audit's role:

> Internal auditors may provide training and/or information on internal control identification and assessment, risk assessment, and test plan development without impairment to objectivity. As the organization's control experts, this would be a natural role.[3]

The SOX bandwagon is unstoppable and there are good reasons why audit plans are becoming immersed in work related to complying with the various spin-offs including the need to document risk management arrangements and internal controls. Research into the impact of SOX reports the following main benefits:

> Three quarters of the financial executives in the Oversight Systems survey said that their company had realized a benefit from Sarbanes-Oxley compliance. The main ones were that it:
>
> Ensures the accountability of individuals involved in financial reports and operations.
>
> Decreases the risk of financial fraud.
>
> Reduces errors in their financial operations.
>
> Improves the accuracy of financial reports.
>
> Empowers the board audit committee by providing it with deeper information.
>
> Strengthens investors' view of the company.[4]

Facilitator

The next stage of our model in Figure 1.1 moves the risk management process forward and involves the auditor adopting a facilitating role. Facilitation is about helping people in the organization adopt and employ Enterprise Risk Management (ERM) to inspire better business results and to embed good accountability throughout the business. Again, many standard audit plans are being revised to focus on this newly appointed task as audit teams start to focus on facilitating ERM as part of their overall mission in life. The IIA paper on audit's role in SOX makes it clear that audit can have a major impact on the way managements develop procedures for making their Section 404 assertions regarding their internal controls over financial reporting, and the way the external auditor, in turn, makes attestations of these management assertions. Section 302 focuses on quarterly reporting of financial reporting controls, and disclosure controls and procedures. While these reporting obligations are clearly the management's responsibilities, internal audit, as the expert in control systems, is seen as having a legitimate role in assisting the projects that must underpin these new disclosures so long as it does not impair audit independence. The traditional 10% planning allowance for contingencies and management requests for additional help falls far short of the usual level of support that audit is being asked to provide for helping set up the procedures for managing disclosure and regulatory risk as well as the normal risks of managing the business. When setting up the consulting role, the auditor needs to be aware of IIA Practice Advisory 1000.C1-2, which suggests that the auditor needs to consider several factors when deciding whether to take on large consulting projects:

- The needs of management officials, including the nature, timing, and communication of engagement results.
- The possible motivations and reasons of those requesting the service.
- The extent of work needed to achieve the engagement objectives.
- The skills and resources needed to conduct the engagement.
- The effect on the scope of the audit plan previously approved by the audit committee.
- The potential impact on future audit assignments and engagements.
- The potential organizational benefits to be derived from the engagement.[5]

It is one thing to help the management get on top of the risk management agenda, but this must be done carefully, as made clear in Practice Advisory 1000.C1-2:

> Care should be taken, particularly involving consulting engagements that are ongoing or continuous in nature, so that internal auditors do not inappropriately or unintentionally assume management responsibilities that were not intended in the original objectives and scope of the engagement.[6]

It is a good idea to check with the audit committee, before throwing the annual audit plan out the window, about diverting chunks of planned work to the risk management project. Most organizations ensure that the audit committee is built into the audit-planning process as indicated by one commentator:

> The Audit Committee has delegated authority to the Senior Vice President—Internal Audit to make/approve changes that meet certain criteria, and report those changes to the Committee. Any changes outside those criteria must be approved by the Audit Committee before adjusting the work plan.[7]

CASE STUDY

Refocusing the Audit Plan

A large public sector internal audit department made many references to the lack of good internal control awareness among business unit managers in all parts of the organization. One of these remarks was featured in the annual report to the governing board, and caused some concern among the senior management team. The proposed annual audit plan submitted to the audit committee focused on follow-up audits in areas in which previous audits had found poor compliance, high levels of error, inconsistent local decisions, and generally unreliable controls. As part of the consultation applied to the draft audit plan, the Chief Audit Executive (CAE) met with the CEO and discussed the problems at the business unit level. It was felt that these concerns related to a generic failure to appreciate the value of good controls and ensure that procedures are applied in a consistent and transparent manner. The CAE asked that the audit plan be reframed to include a large project for promoting better control awareness among managers and supervisory staff levels. It was felt that the follow-up audits would simply confirm that there were ongoing problems resulting from a poor control culture and that the year-long project would aim to tackle the root cause of this problem. The second round of consultation on the proposed audit plan generated much more enthusiasm and it was decided by the audit committee as the best use of the audit resource, for the year in question.

Advisory

The ERM maturity spectrum in Figure 1.1 moves further right as the organization develops more confidence in the way it establishes ERM. In this scenario, audit teams are able to move back from the intense championing and facilitating positions and simply assume an advisory role as the audit consulting arm takes a back seat. The gaps that the consulting work had been causing in annual audit plans can be made good and audit teams may embark on more formal planning schemes as envisaged by good commercial practice:

> Typically, an annual audit planning process should start with the review of a company's audit universe, which is a risk-rated, comprehensive list of all auditable areas within a company. Risks should be assessed based on the perceived strengths and weaknesses of the internal controls, the security over systems, and the reliability of the personnel responsible for such controls and systems.[8]

Assurance

Our model in Figure 1.1 suggests that assurance services are reinforced when the organization has arrived at some degree of risk maturity. Audit can now turn to providing a formal opinion on the state of risk management and reported disclosures. Assurance services are defined by the IIA as:

> An objective examination of evidence for the purpose of providing an independent assessment on risk management, control, or governance processes for the organization. Examples may include financial, performance, compliance, system security, and due diligence engagements.[9]

The key word in this definition is *independent*. It is independence that makes the audit input invaluable to the board and its audit committee by providing an objective perspective on the way risk is being managed within the organization. Before audit plans can be properly formulated within a changing governance context, it needs to be made clear that audit has to step back from aspects of the business projects that it was previously immersed in. It is not simply a case of moving from a consulting role to an assurance role as the organization comes to grips with its risk management process. Audit standards make clear the need to ensure that this distancing task is properly managed. Practice Advisory 1130.A1-1 deals with assessing operations for which internal auditors were previously responsible and can be used to deal with the transition from being the corporate risk champion to providing formal assurances on the state of risk management. The practice advisory suggests that:

> Objectivity is presumed to be impaired when internal auditors audit any activity for which they had authority or responsibility within the past year. These facts should be clearly stated when communicating the results of an audit engagement relating to an area where an auditor had operating responsibilities.
>
> Persons transferred to or temporarily engaged by the internal audit activity should not be assigned to audit those activities they previously performed until a reasonable period of time (at least one year) has elapsed. Such assignments are presumed to impair objectivity, and additional consideration should be exercised when supervising the engagement work and communicating engagement results.
>
> 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. Objectivity is considered to be impaired if the auditor designs, installs, drafts procedures for, or operates such systems.

> The occasional performance of non-audit work by the internal auditor, with full disclosure in the reporting process, would not necessarily impair independence. However, it would require careful consideration by management and the internal auditor to avoid adversely affecting the internal auditor's objectivity.[10]

If the audit department is going to lead on a SOX/ERM project, then it may be a good idea to use a consulting-based audit team that is differentiated from the assurance work performed by the other teams. In this way, the consulting role can be carried out by people who will not immediately perform assurance work on the SOX/ERM arrangements in line with the remit of the practice advisory. There is a great deal of help and assistance that auditors can provide without being deemed as interfering with the formal assurance role. One further consideration is the need to ensure that any project work does not impair the reporting arrangements so that audit report to line personnel and do not fall foul of Practice Advisory 1110-2:

> The CAE should also ensure that appropriate independence is maintained if the individual responsible for the administrative reporting line is also responsible for other activities in the organization, which are subject to internal audit. For example, some CAEs report administratively to the chief financial officer, who is also responsible for the organization's accounting functions. The internal audit function should be free to audit and report on any activity that also reports to its administrative head if it deems that coverage appropriate for its audit plan. Any limitation in scope or reporting of results of these activities should be brought to the attention of the audit committee.
>
> CAEs should also consider their relationships with other control and monitoring functions (risk management, compliance, security, legal, ethics, environmental, external audit) and facilitate the reporting of material risk and control issues to the audit committee.[11]

Audit departments that assume the risk management role along the lines of, say, forming a department called *Internal Audit and Risk Management* must bear in mind the difficulty in subsequently auditing the work of the risk management function. Some audit teams kick-start the risk management function and possibly transfer a couple of audit staff into the new team. But they then encourage a degree of distance from the team as, over time, it settles down and forms a reporting line to defined parts of the business, such as corporate planning or finance. Whatever the approach, it is important to help build the progress that the organization is making on SOX/ERM and ensure that the changing inputs from internal audit are built into the audit-planning process. ERM has been placed alongside SOX not just as a convenience but as a way of recognizing the important link between these two concepts. SOX creates tighter governance arrangements that drive better accountability and include many published disclosures that underpin the new measures. One of these disclosures relates to the state of internal control over financial reporting. Controls are a response to risks that impact business objectives, including the risk that disclosure requirements are not achieved. ERM is a basic necessity and part of the infrastructure that supports good internal controls. ERM means that objectives are set, and risks are identified and assessed and therefore controls may be designed to mitigate risk to an acceptable level. The development of governance processes and disclosures sits alongside the growth in ERM and it is possible to discuss these two matters together, to reflect their interdependency.

CASE STUDY

Changing Audit Approaches

An auditor in a large life assurance company had spent the best part of two years implementing a Control Self-Assessment (CSA) program in all the local offices located in many states, as well as a major head office program. The CAE provided regular updates on the progress made with CSA in each of the quarterly audit reports that were provided to the audit committee. On receiving praise from the audit-committee members for the success of the CSA program, the board considered including an item to ensure that management assertions regarding the systems of internal control were reliable. The board asked the CAE to feed into the quarterly control disclosures by providing an opinion on the reliability of management assertions and a formal perspective on the state of internal controls across the organization. The CAE reduced the level of CSA support work and asked the audit staff to focus on testing the reliability of controls and find out whether management control reviews were carried out in a meaningful manner. The annual audit plan was revised to include built-in reviews of all high-risk systems, consider how CSA was applied and if the results could be counted on by the top management.

IAP, EAP, and CAP

In the past, audit planning was pretty straightforward. The Internal Audit Plan (IAP) was prepared each year on the basis of the previous year's framework and simply contained a list of worthwhile audits that meant the audit resource was spread around parts of the organization over the ensuing twelve months. This format was normally accepted as a good enough way of discharging audit's role. Nowadays, this falls short of world-class practices, and most organizations today have a clear idea of the Expected Audit Product (EAP), as the top management and nonexecutives know what a good audit department should be providing, within the new governance context. Also, consulting work should be fitted into the plan:

> 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 organization's operations. Those engagements that have been accepted should be included in the plan.[12]

The final factor relates to the Competitors' Audit Promises (CAP) in the form of representations from external providers of internal audit services. This means the in-house audit plans may well be compared to the types of services that other audit providers can supply, and again the audit committee will have a good idea of what is on offer. When the plan is ready, it should be formally released:

> The chief audit executive should communicate the internal audit activity's plans and resource requirements, including significant interim changes, to senior management and to the board for review and approval. The chief audit executive should also communicate the impact of resource limitations.[13]

The internal audit plan, in this scenario, becomes a crucial part of the CAE's agenda, as it needs to be focused, flexible, and well positioned to meet the needs of extremely demanding, regulatory and performance-driven organizations. In essence, the internal audit plan needs to be risk based to be of any real use in addressing the risks arising from possible external competition and enhanced expectations from executives and nonexecutives alike. The IIA's definition of an internal audit activity is in fact quite wide and incorporates different ways that audit work may be resourced:

> 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 organization's operations. The internal audit activity helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.[14]

The best audit plan is one that provides the results that are expected by stakeholders:

> Senior management and the board normally expect that the chief audit executive (CAE) will perform sufficient audit work and gather other available information during the year so as to form a judgment about the adequacy and effectiveness of the risk management and control processes. The CAE should communicate that overall judgment about the organization's risk management process and system of controls to senior management and the audit committee. A growing number of organizations have included a management's report on the risk management process and system of internal controls in their annual or periodic reports to external stakeholders.[15]

It is always a good idea for the CAE to work toward the best audit plan and, therefore, the best audit result possible.

RISK-BASED AUDIT-PLANNING MODEL: PHASE TWO

So far our model has been built on the framework that represents the change in audit's role, in response to the development of ERM from the changing role. Our model is further enhanced in Figure 1.2 in recognition of this fact.

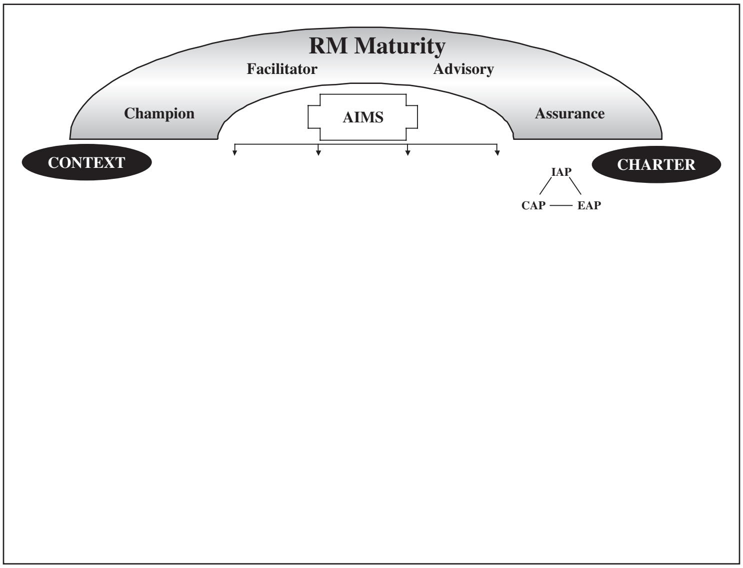
Each new aspect of the model is described in the following paragraphs.

Context

Now, more than at any other time, the context in which audit planning occurs is extremely important. SOX results in a great deal of focus on corporate social responsibilities and ethical values. Risks that arise from poor codes of ethics or codes that have not been properly embedded within the business may not sit on the board agenda but can cause tremendous problems if not managed effectively. Robert Moeller and Herbert Witt have discussed the impact of SOX:

> Internal audit functions need to accept this new challenge. The designated accounting and financial expert on the audit committee needs the help of internal audit to explain internal control issues within the organization, to better assess audit risks, and to plan and perform effective internal audits. Internal audit now typically has a level of responsibility to SOX Section 404 reviews of internal controls in the organization…[16]

Figure 1.2 Risk-Based Audit-Planning Model: Phase Two



SOX not only creates formal responsibilities for the CEO, board, and audit committee but it also creates additional responsibilities for the CAE. These additional responsibilities in turn create a new context for the audit plan, and one commentator has documented this trend:

> Corporate Governance Committee demands will be incorporated into the plan as this committee take on more specific roles and require validation and verification.[17]

Internal audit may plan to bring to bear an impressive array of tools to assist the organization as it grapples with the new SOX requirements, including the following:

- *Flowcharting.* Many companies are responding to SOX by documenting their financial systems and ensuring that these systems are properly understood and acted upon throughout the organization. Auditors have quite a track record in both documenting systems and testing that they are actually working as intended.
- *Risk database.* Another development is the compilation of a detailed risk register or database that records major risks and where they fall across the organization. This is another area where audit have some expertise in that many audits involve tracking risks and assessing which ones need to be mitigated.

- *Employee surveys.* There is a growing use of surveys to check on issues such as the state of control awareness, understanding of risk, degree of control compliance, and perceptions of ethical behavior. These issues all contribute to the development of a good control environment, and many audit teams have spent time using such surveys to check where the organization stands in risk and control practices.
- *Corporate compliance checks.* SOX and other regulatory guidance require that organizations get a grip on their internal controls and ensure that the workforce properly observe the risk management arrangements. The importance of compliance reviews is pretty much ingrained in many audit departments and there is a great deal of help that auditing can provide in teaching the management the ways of promoting and monitoring compliance with control routines.
- *Data interrogation.* Control standards are based on high levels of success in business and support systems and processes. Rogue transactions can creep into any system where human error, system failures, and unforeseen circumstances kick in to cause problems for the organization. Attention to the integrity of systems throughout the organization can be checked through interrogating the data and ensuring that incorrect or inappropriate transactions are quickly identified and corrected. Powerful data interrogation tools have been used by auditors for many years and are an important part of the measures to help achieve well-controlled systems:

  > In exercising due professional care the internal auditor should consider the use of computer-assisted audit tools and other data analysis techniques.[18]

- *Risk profiling.* Internal control is based on tackling risks before they harm the business. It is this understanding of risk that enables the management to ensure that there is good control. Risk profiling is essential in helping ascertain where the risks are and how they impact the organization. Again, auditors have a lot to offer in helping this happen.
- *Fraud detection.* The final example of audit tools relates to fraud detection. Many of the problems that led to the emergence of SOX resulted from corporate fraud and a generally lax attitude to accounting policies and practices. Each organization needs to have in place a sound antifraud policy, including a fraud detection strategy, if it is to report that controls are generally sound. The auditors, while not specialist fraud investigators, can help create the type of culture

where the risk of fraud is appreciated and addressed at all levels in the organization:

> The internal auditor should have sufficient knowledge to identify the indicators of fraud but is not expected to have the expertise of a person whose primary responsibility is detecting and training update specialist skills.[19]

The question then arises as to how to best build the use of these tools into the audit-planning process. Tools that used to be applied to individual audits may now be applied across the business to promote a corporate wide initiative to get financial and disclosure controls documented, tested, and improved. It is difficult to see how the audit team can prepare a long-term plan without taking on board the pressing need to respond to challenging new demands on the business.

CASE STUDY

Using ERM as the Driver

One audit department consisting of seven audit staff reporting to the CAE was asked to present a paper on ERM to their audit committee. The paper covered the implications of establishing an ERM process throughout the organization and the need to set up a suitable infrastructure based on the risk policy. The audit committee asked the CAE to take the lead on this task and redirect at least two audit staff to work over the next six months to provide ways for taking the ERM process forward. The current annual audit plan was redrafted with this in mind and the work undertaken by the two auditors was described as an audit-consulting project. The audit committee defined the failure to install ERM as one of their biggest risks and accepted cuts in other parts of the audit plan to fund this new work.

Charter

The right-hand side of Figure 1.2 brings the audit charter into the audit-planning process. In the past, this consideration was straightforward, as most charters would simply state that internal audit would seek to add value to the organization in line with the formal definition of the audit function. Before we explore this idea further, it is appropriate to define the charter:

> The charter of the internal audit activity is a formal written document that defines the activity's purpose, authority, and responsibility. The charter should (a) establish the internal audit activity's position within

> the organization; (b) authorize access to records, personnel, and physical properties relevant to the performance of engagements; and (c) define the scope of internal audit activities.[20]

We have suggested that the audit role adopted must be aligned to the position that the organization has achieved in terms of designing and implementing an effective response to SOX/ERM requirements.

CASE STUDY

Internal and External Audit Roles

The audit charter of a small private sector audit team made a clear distinction between the work of the external auditor as compared to the work of the internal auditor. The internal auditor's work was related to nonfinancial systems so as to keep clear of the external auditor's verification of financial statements. The Audit Committee (AC) asked the CAE to include accounting systems within the scope of IA work, particularly relating to the application of accounting policies and practices that impacted the financial statements. The audit charter was changed to reflect this measure and made mention of IA supporting the board in the way it formulated its corporate disclosures regarding internal controls over financial reporting.

IIA Standard 1000 makes it clear that internal audit's role should be defined in a charter, consistent with the standards, and approved by the board. Note that when a standard indicates that something should happen, this means, according to the IIA's glossary of terms, it is a mandatory obligation. Before we can talk about audit planning, we need to work out where our responsibilities lie. There is help at hand in the form of IIA guidance:

> Risk management is a key responsibility of management. To achieve its business objectives, management should ensure that sound risk management processes are in place and functioning. Boards and audit committees have an oversight role to determine that appropriate risk management processes are in place and that these processes are adequate and effective. Internal auditors should assist both management and the audit committee by examining, evaluating, reporting, and recommending improvements on the adequacy and effectiveness of management's risk processes. Management and the board are responsible for their organization's risk management and control processes. However, internal auditors acting in a consulting role can assist the organization in identifying, evaluating, and implementing risk management methodologies and controls to address those risks.[21]

Each audit charter should reflect the emerging role of audit in improving corporate governance, and IIA guidance creates a challenge in this respect:

> Section 404 of Sarbanes-Oxley requires management's development and monitoring of procedures and controls for making their required assertion regarding the adequacy of internal controls over financial reporting, as well as the required attestation by an external auditor, regarding management's assertion. Section 302 deals with managements' quarterly certification of not only financial reporting controls, but also disclosure controls and procedures. The requirements of Sarbanes-Oxley place responsibilities on both management and independent accountants. The Standards require that the internal audit activity evaluate and contribute to the improvement of the organization's risk management, control, and governance processes through consulting and assurance activities.[22]

Aims

Our model includes the aims of the audit department as a fundamental aspect of the planning process. In one sense, planning is about taking steps to ensure that the aims set are achieved and these aims need to be fully clarified before we can move on. Moreover, the actual aims of the audit process must be set against the context outlined earlier. We can turn to authoritative guidance to start our discussion:

> Internal audit functions typically provide an assessment of risks and control activities of a business unit, process, or department. These assessments provide an objective perspective on any or all elements of enterprise risk management, from the company's internal environment through monitoring. In some cases particular attention is given to risk identification, analysis of likelihood and impact, risk response, control activities, and information and communication. Internal audit, based on its knowledge of the business, may be positioned to consider how new company initiatives and circumstances might affect application of enterprise risk management, and to take that into account in its review and testing of relevant information.[23]

This viewpoint is reinforced in the New York Stock Exchange Rules that require every listed company to have an internal audit function to provide management with an ongoing assessment of the company's risk management process and systems of internal control. In terms of SOX compliance, most experts agree that internal audit should offer a significant amount of support and guidance. Most listed companies are establishing formal projects to design and implement a suitable response to SOX, and internal audit will need to sort out how it can best assist this task. One auditor has commented on the impact of disclosure requirements:

> There will be a SOX component in every audit program we execute, as an independent verification that management is performing work for their quarterly sub-certifications.[24]

When defining aims, the CAE needs to be aware of overall responsibilities for managing the audit team:

> The chief audit executive is responsible for properly managing the internal audit activity so that:
>
> Audit work fulfills the general purposes and responsibilities described in the charter, approved by the board and senior management as appropriate.
>
> Resources of the internal audit activity are efficiently and effectively employed.
>
> Audit work conforms to the International Standards for the Professional Practice of Internal Auditing (Standards).[25]

Using the IIA standards as a framework, the CAE will need to set out the audit objectives, which may include the following:

1. **Objective.** Provides independent, objective assurance and consulting services. The IIA defines objectivity as:

   > An unbiased mental attitude that *allows* internal auditors to perform engagements in such a manner that they have an honest belief in their work product and that no significant quality compromises are made. Objectivity requires internal auditors not to subordinate their judgment on audit matters to that of others.[26]

2. **Adds value.** Designed to add value and improve an organization's operations. The IIA defines value add as:

   > Value is provided by improving opportunities to achieve organizational objectives, identifying operational improvement, and/or reducing risk exposure through both assurance and consulting services.[27]

3. **Achieves objectives.** Helps an organization accomplish its objectives. The auditors need a good understanding of what the management is seeking to achieve. Management's role is set out by the IIA:

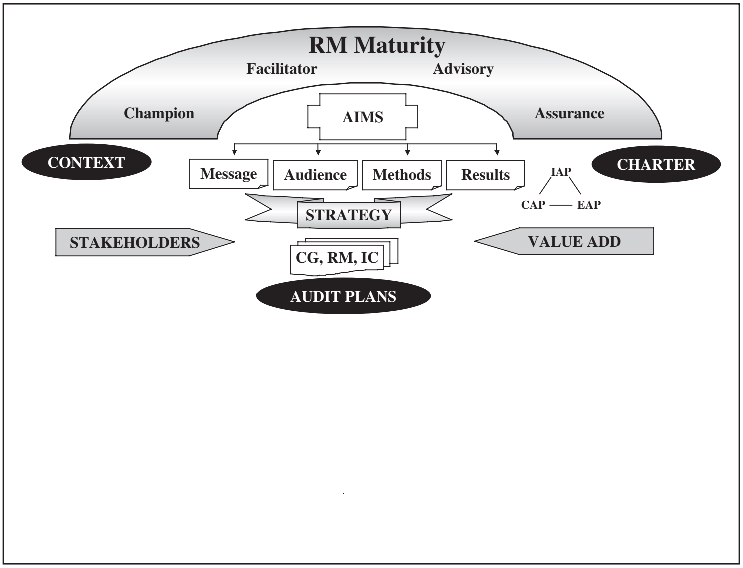
Management plans, organizes, and directs the performance of sufficient actions to provide reasonable assurance that objectives and goals will be achieved. Management periodically reviews its objectives and goals and modifies its processes to accommodate changes in internal and external conditions. Management also establishes and maintains an organizational culture, including an ethical climate that understands risk exposures and implements effective risk strategies for managing them.[28]

4. **Professional.** Brings a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. Audit plans will need to demonstrate exactly how this objective will be achieved. Conversely, published plans that are not linked to this task may well be substandard.

RISK-BASED AUDIT-PLANNING MODEL: PHASE THREE

Our model is continued in Figure 1.3.

Figure 1.3 Risk Management Framework Model: Phase Three



Each new aspect of the model is described in the following paragraphs.

Stakeholders

The concept of stakeholders has grown over the years to have a huge impact on all types of organizations. Commercial companies can no longer just make large profits to be successful—they need to take on board the needs and expectations of all key stakeholders who are affected by the way they work. Public service stakeholders means that federal and state government officials cannot simply aim at a range of targets, but must also judge the way their services impact the client groups and the general public. Likewise, auditors need to build the concept of stakeholders into the planning process in terms of who will lose out if the audit process is flawed or simply inefficient. There are many groups who are affected by the services that are being delivered, or for that matter, audit services that are not being properly delivered, including:

- *The audit committee.* The audit committee will need to review and approve all audit plans and will want these plans to demonstrate that they make good use of scarce audit resources.
- *The board.* The board will be concerned that audit plans feed into the corporate agenda to improve governance, risk management, and internal control—and ensure that they receive an objective opinion on whether enough is being done in this respect.
- *The CEO and PFO.* The Chief Executive Officer (CEO) and Principal Finance Officer (PFO) assume personal liability for many governance disclosures and they will want audit plans to do as much as possible to ensure there are no slip-ups that damage the corporate reputation.
- *Senior management.* Top management will look to the audit plans for help in getting ERM in place.
- *The external auditor.* Internal audit plans should feed into the work that is carried out by the external auditor to form a comprehensive “audit process.” The external auditor will want the internal audit plans to enrich this concept and provide a platform for solid audit work for the year to come.
- *The customer.* So far, not many audit shops acknowledge the fact that their services reach out beyond the corporate boundary and help give credibility to the products that end up with the customer. As such, the customer may be seen as a stakeholder for the auditor and has a stake in the audit plans that are prepared and implemented within the organization. Customers may rest easy if they feel that

the organizations they subscribe to are well run, perform well, and adhere to all relevant rules and regulations.

- *The corporate investor.* Many corporate scandals have left scars on investors who have lost money. CAEs may do well to think through the expectations of corporate investors and the way in which they might benefit from a high-impact risk-based audit plan that tackles important parts of the organization.

The main expectation of stakeholders is that the audit process is planned and performed with professional proficiency:

> Professional proficiency is the responsibility of the chief audit executive (CAE) and each internal auditor. The CAE should ensure that persons assigned to each engagement collectively possess the necessary knowledge, skills, and other competencies to conduct the engagement properly.[29]

Value Add

We have already mentioned that added value sets an important challenge for the CAE, but there is a word of warning from WorldCom at spending too much time chasing the "golden goose" of value add:

> At WorldCom, risk analysis was instead performed with the goal of selecting audits that could add "value" to the Company by emphasizing revenue enhancements and cost reductions. Moreover, the lack of any consultation with Arthur Andersen resulted in gaps in audit coverage. Given the absence of a comprehensive risk-based internal audit plan, there was no apparent relationship between the audits scheduled annually and the risk and the effectiveness of internal controls associated with these audit areas.[30]

The concept of value is nonetheless important as each part of the organization has to have some form of value proposition:

> The value proposition of the internal audit activity is realized within every organization that employs internal auditors in a manner that suits the culture and resources of that organization. That value proposition is captured in the definition of internal auditing and includes assurance and consulting activities designed to add value to the organization by bringing a systematic, disciplined approach to the areas of governance, risk, and control.[31]

One issue that supports the value add concept is the type of services that audit provides in helping improve the organization's risk management process. Research funded by the IIA Research Foundation considered the question: *To what extent is internal auditing involved in these ERM activities?* [32] The results are shown in Figure 1.4.

We would expect that the value added by the auditors is maximized by the use of risk-based audit planning, which means the CAE will need to consider:

- Clarifying audit's role in risk management.
- Ensuring how it can help ensure that ERM itself adds value to the organization.
- Resourcing ERM training and development programs for the workforce.
- How to help the organization progress through the stages of ERM maturity.

Figure 1.4 To What Extent Is Internal Audit Involved in ERM Activities?

Scale ranging from 1–5:

1: No internal audit activity

5: Extensive internal audit activity

Internal Auditing is involved in:	**Response**
Coordinating ERM efforts among internal auditing and others	3.8
Assisting with risk identification in ERM (establishing list of possible risks)	3.7
Suggesting control activities to ensure risk response is in place	3.7
Monitoring the ERM process	3.7
Providing ERM leadership in the organization	3.6
Providing ERM education in the organization	3.5
Performing risk assessments in ERM (considering likelihood and impact)	3.5
Assisting with identifying risk responses (deciding how to respond to risks)	3.0

Source: Internal Auditing Journal, February 05, page 71, ERM: A Status Report, survey funded by the IIA Research Foundation, 2004.

- Producing audit plans that are driven by the strategic risks facing the organization.
- The extent to which the audit plans to incorporate an understanding of risk dependencies and interdependencies.
- The way that ERM is being used to employ a holistic approach to risk management within the business.
- Moving away from silo audit plans to holistic enterprise wide risk-based plans.
- Focusing on the business, business processes, risks, and internal controls.
- Using the corporate risk database and the expertise of corporate risk specialists
- Using the audit process to provide a health check on the state of ERM within the organization.

It is only after considering items such as those listed above that we can really start talking about achieving top value from the audit process.

Message, Audience, Methods, and Results

The next item on our Model relates to the need to ensure that audit planning takes on board the need to get the audit mission into the organization by focusing on four main matters:

1. **Message.** The audit plan sets out what audit will be doing in the future and in this way communicates important messages about what audits see as important and what does not make it to the table. If these messages are out of step with perceptions of importance in the business itself, then they may convey a view that audits are not aligned with the corporate agenda.
2. **Audience.** Another issue that has to be addressed when formulating the audit plan relates to the target audience. Stakeholders were discussed earlier and these groups are directly or indirectly the audience for audit services. The audit-planning process should be based on a careful consideration of who receives drafts and final versions of the plans. It should also consider ways to generate interest among the target audience so that people are encouraged to look forward to the planning documents and can appreciate how the work will benefit them.

3. **Methods.** Audit planning must adhere to an agreed methodology for it to make any sense. The adopted methodology will be one that suits the organization and satisfies the CAE, audit committee, and board. Methodology should be based on risks to the business, whatever be the detailed model in use.
4. **Results.** It is important to return to first principles to work out why we plan and what results we expect from risk-based audit plans. Good plans should lead to excellent work, well-informed managers who know when an audit will occur, and well-motivated auditors who can see how they will be contributing to the organization over the ensuing months and years.

The four-pronged approach is necessary to drive the audit process through the organization in a way that is understood and appreciated. Paul Sobel has defined an important aspect of the audit-planning process by suggesting that auditors must:

> Plan their audit activities to periodically reassess the design and operation of key risk management processes.
>
> Make periodic evaluations of the ongoing accuracy and effectiveness of the communications from risk owners to senior management, and from senior management to the board.[33]

This essential task must not only be carried out but should be carried out in such a way that the value is fully appreciated in the organization. SOX has caused some concern among both executives and nonexecutives and the auditors are, in a sense, rushing to the rescue. The new audit-planning approach has come on board to address this issue as described below:

> Assessing risks in real-time means that identifying and evaluating risks is an ongoing, infinite process that cannot be accomplished in a once a year, weeklong exercise. Organizations, their markets, and the general business environment are constantly changing, and the risks affecting the organization change right along with them. To stay on top of an entity's dynamic risk environment, internal auditing's processes for assessing risk must include mechanisms for continually acquiring new risk information.[34]

The approach to auditing risk management in one organization will differ from what is used in other organizations. This point is fully recognized in auditing standards, which means a rigid checklist approach can be useful but must be used with care.

Internal auditors should recognize that there could be significant variations in the techniques used by various organizations for their risk management practices. Risk management processes should be designed for the nature of an organization. Depending on the size and complexity of the organization's business activities, risk management processes can be:

Formal or informal.

Quantitative or subjective.

Embedded in the business units or centralized at a corporate level.[35]

Strategy

The next item to be addressed is strategy, which appears as the central component of our model. The context has been set in terms of the ongoing development of ERM that appears in most organizations. But, before getting to the more detailed aspects of the audit-planning process, there needs to be a clear strategy in place that drives the audit department. Strategy is about setting a long-term direction for ensuring that we know how we are currently positioned with an organization, and working through where we want to be and how we can progress toward the aspired position. In formulating strategy, there are five fundamental questions to be addressed:

1. Where do we currently stand in the organization and where do we want to be in one-, two-, or three-years' time?
2. What services do we currently provide to the organization and what do we want to provide in one-, two-, or three-years' time?
3. How are we currently perceived by our stakeholders and how do we want to be perceived in one-, two-, or three-years' time?
4. How does our audit team currently perform in terms of efficiency and effectiveness and how do we want them to perform in one-, two-, or three-years' time?
5. To what extent do we currently add value to the organization and to what extent do we want to add value in one-, two-, or three-year's time?

These five questions could be addressed by the audit team if it carried out a risk assessment, and considered threats and opportunities to the set audit objectives, using the five items as a platform for this task. If the auditors recommend risk management throughout the business by calling it ERM, there is really no good reason why this technique could not be used by the auditors themselves. Paul Sobel has given a clue as to the drivers that may be used to support a change in audit strategy, as we move into the new ERM dimension by considering four levels of change in the approach to audit work:

1. Control-based auditing
2. Process-based auditing
3. Risk-based auditing
4. Risk-management-based auditing[36]

As audit teams move into risk-management-based auditing, the audit strategy will need to change to reflect the new challenges, and Sobel goes on to suggest that risk-management-based auditing is a key part of a successful ERM program. In fact, we may well be moving into ERM-based auditing, where the audit process is determined by the risks facing the organization and the way risk is being managed as suggested in the following case study.

CASE STUDY

Focusing on Disclosure Risk

One organization assumed a wide concept of risk management that addressed the risk of poor business performance but also incorporated the risk of:

- Poor SOX compliance.
- Failure to document, evaluate, test, and operate effective controls.
- Poor understanding among management of their responsibilities for internal control over business operations and financial reporting.
- Failure to identify and report "material weaknesses" in internal control over financial reporting.
- Inability to track changing risks and ensure that they are mitigated if they result in exposures outside the corporate risk appetite.
- Lack of appreciation of the importance of corporate social responsibilities and codes of conduct.
- Poor coordination of assessment work that support Sections 301, 302, and 404 that result in duplication of effort.

The audit department was asked to take into account these risks when setting their annual audit plan and help review and monitor these risks, as well as test for compliance, in almost all audit work that was carried out across the organization. One spin-off was a turnaround in audit staff where facilitation skills were prioritized and auditors received detailed training in ERM and governance.

Audit strategy feeds into audit plans, while audit plans determine the types of audit products to be delivered. If this equation is ignored, the final result may well be an audit service that is substandard and poorly thought out. The audit strategy also provides a framework that defines the auditors' input into the risk management process, and the balance between audit assurance and consulting services will have to be carefully planned against the risk maturity concept discussed earlier.

CG, RM, and IC

The next item in our model, which appears before we get to the actual audit plans, includes Corporate Governance (CG), Risk Management (RM) and Internal Control (IC) dimensions. These are defined as follows:

> **Corporate Governance:**
>
> The combination of processes and structures implemented by the board in order to inform, direct, manage and monitor the activities of the organization toward the achievement of its objectives.[37]
>
> **Risk Management:**
>
> A process to identify, assess, manage, and control potential events or situations, to provide reasonable assurance regarding the achievement of the organization's objectives.[38]
>
> **Control:**
>
> Any action taken by the management, the board, and other parties *to manage* risk and increase the likelihood that established objectives and goals will be achieved. The management plans, organizes, and directs the performance of sufficient actions to provide reasonable assurance that objectives and goals will be achieved.[39]

It is a good idea not to forget the three components of audit work when setting the audit plans. The audit plans will focus on how auditors can make a positive contribution to improving governance, risk management, and controls within the organization by addressing several important questions:

- How can audit contribute to better governance?
- What is the state of play with ERM and how can audit stimulate progress?

- How effective are internal controls and does the current control framework deliver results?

It is also important to keep in mind the formal scope of audit work when considering audit's role in risk management:

> Based on the results of the risk assessment, the internal audit activity should evaluate the adequacy and effectiveness of controls encompassing the organization's governance, operations, and information systems. This should include:
>
> Reliability and integrity of financial and operational information.
>
> Effectiveness and efficiency of operations.
>
> Safeguarding of assets.
>
> Compliance with laws, regulations, and contracts.[40]

Audit Plan

The final part of this stage of the model is the actual audit plan. A good starting place is the IIA standard that tackles audit planning:

> The chief audit executive should establish risk-based plans to determine the priorities of the internal audit activity, consistent with the organization's goals.[41]

Good audit plans have the following attributes:

- Promote shareholder confidence.
- Represent a good use of the audit budget.
- Enhance corporate reputation.
- Reflect organizational values, goals, and conduct.
- Increase auditors' motivation.
- Ensure that the delivery of audit services has a major impact on the organization.
- Keep the regulators happy.
- Make life easier for the external auditors.

Another way of viewing risk-based audit plans is to suggest that good plans guard against the risk of not achieving the above mentioned attributes. The audit plan should be risk assessed and inclusive in the way it is developed:

> The internal audit activity's plan of engagements should be based on a risk assessment, undertaken at least annually. The input of senior management and the board should be considered in this process.[42]

A short case study follows.

CASE STUDY

Scoring Audit Units

An audit team established a risk assessment model based on the format shown in Figure 1.5.

Figure 1.5 Scoring Audit Units

Audit Area	Risk Factor 1 Materiality	Risk Factors 2 Importance to the Business	Risk Factor 3 Audit Committee Requests	Rating
Xxx				
Yyy				
Zzz				

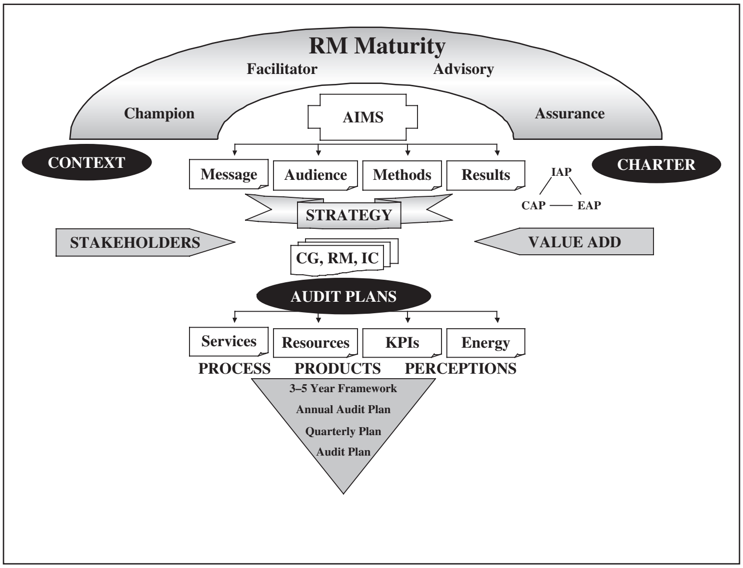
Having assigned a score where each audit area is scored high, medium or low risk the following audit cycle length is set:

High risk areas:	Audited every year
Medium risk areas:	Audited every two years
Low risk areas:	Audited every three years

RISK-BASED AUDIT-PLANNING MODEL: PHASE FOUR

Our model continues in Figure 1.6.

Figure 1.6 Risk-Based Audit-Planning Model: Phase Four



Each new aspect of the model is described in the following paragraphs.

Services

The next item that should be considered during audit planning is the types of services that audit perform. There are several aspects of audit work to be noted:

Review operations:

Internal auditors should consider all parts of the business and not just the financial systems:

> Internal auditors should review operations and programs to ascertain the extent to which results are consistent with established goals and objectives to determine whether operations and programs are being implemented or performed as intended.[43]

Compliance:

Internal auditors should be concerned about the degree to which the organization is in compliance with all relevant laws, rules, regulations, and procedures. Audit work may focus on checking compliance or concentrate on reviewing the arrangements that are designed to promote compliance with procedures.

Consulting projects:

Auditors may engage in consulting projects where they work primarily for the manager who has requested the work. These consulting engagements should be built into the plan as far as possible, or resourced from a contingency allowance for additional work. Larger projects may mean that a revised plan will have to be submitted by the CAE to the audit committee during the year.

Assurances on internal control:

An important audit service, based on much of the existing audit work, is formal assurance on the internal controls applied by the organization. This opinion may be the culmination of the individual audits performed during the year or may be derived from special reviews of the internal control environment and the controls reporting arrangements.

Corporate governance arrangements:

Most audit shops are starting to advise top management about any failings in the governance arrangements that are in place within the organization. These failings may result from a lack of proper observance of corporate policies such as those relating to conflict of interests not being declared by board members. Failings may also be about not living up to the best practice guidance issued by regulatory bodies and authoritative sources.

ERM:

Internal audits must be prepared to formulate an opinion on ERM. This means commenting on whether the organization has developed suitable arrangements for identifying and dealing with risks to the business and taking on board guidance such as that found in the COSO ERM document. Audit plans need to reflect this growing dimension of audit work for it to be of real value to an organization.

Facilitation and awareness training:

Many audit shops are making space in the audit plan for helping to kickstart or implement risk management programs and risk/control awareness training across the organization. As such, allowance has to be made in audit plans for time to be spent on these projects, as they form part of many audit teams' core services.

Advice and information:

Rather than engage on large projects to help implement risk management within an organization, many audit teams are providing a low-key support role. This support may consist of general advice or information made available to managers, supervisors, and work teams as and when required. This all-important aspect of audit work needs to be resourced, and again, audit plans have to be adjusted to allow for time spent on this aspect of audit work.

Others:

This category is included here to reflect the need for a flexible approach to audit planning when new issues may appear on the board agenda that are sent down to the auditors. If the board feels it is important and if this view is endorsed by the audit committee and falls in line with audit standards, then the work may be reflected in audit plans. This open door policy moves audit into the real world outside the audit offices, where problems occur and everyone is asked to rally round the agreed solutions. Audit independence should nonetheless be preserved:

> Impairments to individual objectivity and organizational independence may include personal conflicts of interest, scope limitations, restrictions on access to records, personnel, and properties, and resource limitations (funding).[44]

Where such impairments are not apparent from the request for audit coverage, the CAE may well get involved in other noncore audit services. Using audit's role to focus audit plans is often the best way forward, and a case study illustrates this approach:

CASE STUDY

Helping the Audit Committee

A small audit team based in a manufacturing company focused their audit plans around the services that they were asked to provide by the audit committee. The terms of reference for the audit team were defined as:

- Compliance
- Information systems
- Value for money

Helping the Audit Committee *(continued)*

Using these three main headings the planning categories were then further refined in terms of corporate risk as:

1. **Compliance**—Key risks:
   a. Breach of control disclosure regulations
   b. Breach of local state laws
   c. Breach of industry specific provisions
   d. Breach of operational procedures
2. **Information systems**—Key risks:
   a. Failure of systems security
   b. Incorrect data processing
   c. Poor contingency arrangements
   d. Substandard systems coming on line
3. **Value for money**—Key risks:
   a. Inefficient operations
   b. Overstocking
   c. Poor business performance
   d. Poor financial management

The audit-planning template involved setting risk scores against each of the risk categories across the organization as shown in Figure 1.7:

Figure 1.7 Audit Planning Template

Audit Topic	1a–d 1–10	2a–d 1–10	3a–d 1–10	Score 3–30

High scoring parts of the organization were then placed into the annual audit plan up to the level that could be handled by the audit team in post. Each year the audits would be rescored to arrive as a new audit plan for the following year.

Resources

Another planning consideration relates to the type of resources that need to be in place to support audit plans. There is much guidance on the best way to consider resources for the audit plan, and IIA standards set the primary challenge:

> The chief audit executive should ensure that internal audit resources are appropriate, sufficient, and effectively deployed to achieve the approved plan.[45]

Where the audit team is too small to deliver the audit plan, steps should be taken to fill this gap through secondment, recruitment, use of temporary and contract staff, and co-sourcing arrangement. Where the audit plan calls for specialist expertise that does not reside with the audit team, help may be secured from an external service provider, which is defined as:

> A person or firm, outside of the organization, who has special knowledge, skill, and experience in a particular discipline.[46]

These external specialists may be used for a variety of jobs as suggested below:

Information technology, statistics, taxes, language translations, or to achieve the objectives in the engagement work schedule.

Valuations of assets such as land and buildings, works of art, precious gems, investments, and complex financial instruments.

Determination of quantities or physical condition of certain assets such as mineral and petroleum reserves.

Measuring the work completed and to be completed on contracts in progress.

Fraud and security investigations.[47]

Key Performance Indicators

We turn next to Key Performance Indicators (KPIs) as an important part of performance management. Good plans, when achieved, lead to good results. The problem is that these plans need to be monitored to ensure that they are carried out as intended, and this is where KPIs come into play. Audit plans should lead to the development of targets that can be tracked by audit management in line with an overall mission:

> The internal audit activity should evaluate and contribute to the improvement of risk management, control, and governance processes using a systematic and disciplined approach.[48]

The results may also be reported to the audit committee to satisfy their need to oversee the efficiency and effectiveness of the audit service. There is a whole range of KPIs that can be used to keep the audit service on track, but in terms of delivering the audit plan, these may include the following items:

- Preparation of a risk-based audit plan that meets the needs of key stakeholders.
- Approval of an annual audit plan by the audit committee in time for the New Year.
- Completion of the annual quarterly audit plan.
- Development of quarterly audit plans that fit in with the logistical issues facing the areas that are being audited.
- Engagement plans that focus on terms of reference that represent the best use of audit resources in conjunction with the type of risks that face the area under review.
- An audit-planning process that is in line with existing best practice in the audit world.

It is quite easy to set out a list of aspirations, but it is much more difficult to turn these into specific, measurable, achievable, result-oriented, and time-based targets that together lead to a good use of the available audit staff.

CASE STUDY

Using the Audit Opinion

In one audit department, the annual audit plan was developed using the categories of work that the audit committee had decided were needed to form the audit reports that they received each year and each quarter from internal audit. They asked for an audit opinion on:

- The governance arrangements.
- The development of an ERM framework and process.
- Internal controls reporting systems, particularly relating to financial systems.
- The overall state of compliance, antifraud arrangements, and ethical conduct within the organization.
- Whether operational procedures in each of the business lines were addressing risk in an appropriate manner.

Using the Audit Opinion *(continued)*

The audit plan contained targets for each of the above and the main driver was that sufficient work needed to be completed by the auditors each year to allow a formal view of the listed items. Moreover, at least one consulting project was required during the year that helped address the way the organization had improved in these areas. The audit committee monitored these targets and was particularly concerned about the overall state of the control culture within the organization as reported through annual surveys and management reports. The CAE was meant to help improve the workforce's basic understanding of governance, risk management, and internal controls and the way these matters were built into the business units, partners, corporate planning, and support services.

Energy

We have placed the idea of "energy" within the model to bring out the importance of using plans to drive the motives and focus of the auditors. Stagnation is extremely dangerous to the audit process if the previous year's plans are updated and rolled forward with minor changes. Stagnation could also occur if a cycle of audits is rolled out, where every part of the organization is visited on a one-, two-, or three-year basis. More now than ever before, audits have been placed in the spotlight where legislators, regulators, and top executives in all types of businesses have been made aware of the importance of auditors in the governance and performance equation. This heightening of expectations has put audit right up front with the top agenda issues that are crucial to organizational success. But at the same time, the enhanced expectations place a burden on the CAE to define, design, and deliver a top-class audit service. The best-set plans have little impact if these plans are not delivered with gusto and some urgency. It is this urgency that makes the difference between an adequate audit service and a world-class one. The CAE can inject energy into the audit team by using the following guidelines:

- Involve the entire audit team in the planning process by getting them to input ideas, do research, and make sure they understand how the plan is developed and approved.
- Make audit managers responsible for defined aspects of the plan under the overall direction of the CAE. Getting the audit managers

to buy into the plans is the best way to motivate them. They in turn will motivate their junior audit staff.

- Let people know what they will be doing over the next quarter so that they can look forward to the work. At the same time, there must be some flexibility built into the process so that the CAE can make changes wherever necessary.
- Take into account career development aspects of the audit team; it may also be possible to incorporate individual preferences in the plan.
- Discuss the plan and any proposed changes in audit manager meetings and audit department meetings and conferences. Listen to views where it makes sense and use draft plans to ensure it is possible to make changes where there is strong feedback.
- Make sure the plan itself is sensible and meets the needs and expectations of key stakeholders.
- Try to move away from the cyclical approach that suggests the auditor does each audit periodically and performs much the same basic tasks on an annual basis. Even where the same audit that was completed last year is being performed this year, the preliminary survey should ensure that the terms of reference reflect current risk profiles.
- Make clear that planning is an important task and leads to professional work that enhances the reputation of the auditors and leads to a better-managed organization.
- Finally, make sure the planning methodology is well defined and understood by the audit team. If done well, a three-year audit strategy should mean that each individual audit and audit task represents a valuable piece of work.

High levels of energy applied by the audit team are great if directed at the right issues and if they produce the right results, as was achieved by one audit department.

CASE STUDY

Dropping the Cyclical Approach

One head office–based audit team for a pharmaceutical group, with over 50 overseas operating companies had operated a cycle of routine audits for many years and managed to review each part of the business once every two years.

Dropping the Cyclical Approach *(continued)*

The audit team was quite used to working through a set audit program in an audit area that it had worked in many times before, and the CAE noticed that many audit staff were demotivated and bored. The CAE moved away from the cyclical audits and adopted a risk-based approach where she completely reformatted the audit plans each year having regard to the corporate risk register and what was deemed important to the organization for the period in question. The outcome was a series of high-level audits that concentrated on key corporate issues and resulted in a marked increase in energy, motivation, and enjoyment from the audit team.

Products

If the audit-planning process is dynamic and takes on board all the issues that have so far been discussed, it would be possible to deliver various significant audit products as described below:

- *An improved risk management process.* The auditor should benchmark where an organization stands in terms of the development of an effective risk management process and work toward improving the position.
- *Better secured IT systems.* Many boards do not have a place for IT security on their agenda as they feel it is a technical matter. If there is no real security officer in place, the auditors will need to make sure that the risk to corporate systems is properly understood and mitigated by management. Corporate governance has as a subset IT governance through which business systems are protected and suitable contingency arrangements are made in the event of an attack, disaster, or systems failure. IT controls are important to all systems, including financial ones, and fraud, error, and breach of regulations can arise where these systems are not properly protected.
- *Corporate social responsibility.* This is another important issue that audit may have to lead on, if it is not already being championed elsewhere in the organization.
- *Help for the external auditors.* External auditors may be helped, based on their evaluation of internal audit's plans and ways suggested to reduce their coverage in respect of areas already addressed by internal audit.

Some audit products are not in fact part of audit's proper workload. These products represent non–audit work where auditing involvement has been requested. Where this happens, due regard should be given to Practice Advisory 1130.A1-2.

> When the internal audit activity or individual internal auditor is responsible for, or management is considering assigning, an operation that it might audit, the internal auditor's independence and objectivity may be impaired. The internal auditor should consider the following factors in assessing the impact on independence and objectivity: International Standards for the Professional Practice of Internal Auditing (Standards); The requirements of The IIA s Code of Ethics; Expectations of stakeholders that may include the shareholders, board of directors, audit committee, management, legislative bodies, public entities, regulatory bodies, and public interest groups; Allowances and/or restrictions contained in the internal audit activity charter; Disclosures required by the Standards; and Subsequent audit coverage of the activities or responsibilities accepted by the internal auditor…If on occasion management directs internal auditors to perform non-audit work, it should be understood that they are not functioning as internal auditors.[49]

Process

One aspect of the planning system that needs to be considered is the way planned audit is actually performed. Audit standards set a basic requirement on this topic:

> The chief audit executive should establish policies and procedures to guide the internal audit activity.[50]

Good plans using good auditors will deliver good results, but only if there is a sound process in place, which means effort gets properly translated into professional work.

CASE STUDY

Engaging Stakeholders

In one audit shop, risk-based audit planning was an important part of the overall audit process, which was as follows:

- Engage with key stakeholders about their objectives and expectations.
- Determine the risk universe that relates to the entire organization, broken down into auditable units.

Engaging Stakeholders *(continued)*

- Formulate a three-year audit strategy based on improving the governance, risk management, and control environment.
- Establish risk-based audit plans that balance consulting work to improve risk management and controls, with assurance work that reports on areas where there are unacceptable levels of risk.
- Construct quarterly audit plans that make a final allocation of audit resources to the planned work areas with a contingency for additional work that may need to be covered.
- Prepare monthly work plans for each member of audit staff and ensure there are briefings and staff meetings that help energize the audit teams.
- Assign a lead auditor to each audit and perform a preliminary survey to refocus the terms of reference for the audit in question.
- Using the set terms of reference, perform fieldwork to perform the audit.
- Discuss findings and talk about ways forward with the line management in question.
- Issue and draft the final report that seeks to improve risk management arrangements and determines the status of the existing conditions.
- Follow up the audit after a suitable time frame to ensure agreed recommendations are implemented.
- Ensure that the cumulative results of audit work can be reported to the audit committee and board in a way that supports control disclosures made by the CEO.
- Ensure that the above is conducted in line with professional audit standards.

Perception

Planning should take on board the image that audit has throughout the organization: that is, how audit is perceived by its principal stakeholders. IIA standard 1220 covers “Due Professional Care”:

> Internal auditors should apply the care and skill expected of a reasonably prudent and competent internal auditor. Due professional care does not imply infallibility.[51]

A second audit standard also comes into play:

> The internal audit activity should be free from interference in determining the scope of internal auditing, performing work, and communicating results.[52]

CASE STUDY

Communicating Aims

A small audit team developed a clear customer focus strategy based on delivering high-impact risk-based audits that kept the clients in close touch with audit plans, engagement dates, fieldwork, and draft audit reports. Much use was made of briefings with the client and electronic files to ensure the company management understood:

- The role of internal audit.
- The way the annual audit plan was put together to focus audit resources on high-risk elements of the organization.
- The timing of audits and the aim to help managers improve the way they assess risk and install controls to guard against them.
- The positive way that controls could be applied to ensure opportunities can be grasped as well as threats contained.
- Feedback surveys are used to secure information regarding the audit service and all information received is acted on by the CAE.

There are several basic steps that the CAE could take to improve the perceived standing of the audit function:

- Work through audit's stakeholders and find out what they know about the audit service and what they expect from their auditors.
- Line up the current audit services against the above and also benchmark them against professional auditing standards and guidance issued by the IIA.
- Include an improvement plan within the audit strategy to grow and improve the audit process.

It is a good idea to continually reassess the views of internal audit's key stakeholders and judge whether this viewpoint can be improved on. Plans that set targets on this matter may be made an important part of the overall audit planning process. There is no short cut and Practice Advisory 2100-3 sets a real challenge for the auditor in suggesting that:

> The chief audit executive should obtain an understanding of management's and the board expectations of the internal audit activity in the organization's risk management process. This understanding should be codified in the charters of the internal audit activity and audit committee.[53]

Three- to Five-Year Framework

The next element of the basic planning model consists of a funnel that starts with the long-term plan and ends with the actual audit. If this link between the different planning horizons is well structured, then high-level aspirations can get translated into actual audit work. Meanwhile, high-level strategic risks can become focused at the detailed operations level, again in actual audit work. Audit standards can be used as a good start place:

> The chief audit executive should establish risk-based plans to determine the priorities of the internal audit activity, consistent with the organization's goals.[54]

Practice Advisory 2010-1 makes clear that long-term plans need to fit with the overall direction of the organization and the way the audit process is meant to help promote this direction:

> Planning for the internal audit activity should be consistent with its charter and with the goals of the organization.[55]

Most audit departments create a three- to five-year plan, although many are now scaling down the planning time frame to shorter periods to reflect that risk change can be so rapid that any plans that seek to reach out over a year may not be worth the effort. Much depends on the type of organization and business sector in question. An oil company may well have a 15-year plan of exploration and penetration, while a software company may predict a product life span in months rather than in years. In the past, audit teams tended to resource a cycle of audits that ensured each part of the organization was audited over, say, a three-year period. Many argue that the audit approach has been developing over the years to move the definition of risk from:

> The chance that audit will not visit parts of the organization where non-compliance and poor performance is happening unbeknown to head office management.

to a newer interpretation of risk:

> The chance that audit will not help the organization optimize its enterprise risk management process and so undermine its governance arrangements and its overall system of internal control, through the provision of effective assurance and consulting services.

The leap from the first to the second levels of audit planning can be tremendous and this forms the basis for most of this book. Superimposed over the move to risk-based auditing is the view that each year the audit function should plan to move forward and progress toward world-class professionalism. Note that the annual audit plan is discussed in some detail later on in the book.

Quarterly Audit Plan

The longer-term plans set out what may be seen as a set of aspirations that audit promises to accomplish rather than as concrete targets. Many view the quarterly planning process as the ideal time frame for firming up these aspirations and formulating clear plans, with dates, targets, and resource allocations. IIA guidance suggests that:

> The planning process involves establishing:
>
> Goals
> Engagement work schedules
> Staffing plans and financial budgets
> Activity reports.[56]

A great deal of this activity may be carried out during the quarterly planning and review process. The audit team may focus on work schedules, assigning work to audit staff and setting targets for the work. Once targets have been set, audit management needs to take steps to ensure that these targets are achieved as suggested by IIA guidance:

> The goals of the internal audit activity should be capable of being accomplished within specified operating plans and budgets and, to the extent possible, should be measurable. They should be accompanied by measurement criteria and targeted dates of accomplishment.[57]

There are some audit teams that have taken the quarterly planning period to the heart of the audit process and restrike the plan every three months as described in the case study:

CASE STUDY

Flexing the Plan

An audit team established a rapid review system where the audit plan was reformulated each quarter, in conjunction with its audit committee. While the

Flexing the Plan *(continued)*

annual plan contained an overall framework for the year's audit work, because of the fast changing environment within which the organization operated, the real planning period was set as a quarterly exercise. For many years, the CAE could not give an assurance that the audits set out in the annual plan at the start of the year were the best use of resources as the year progressed. This situation existed for some time before the audit committee agreed that the quarterly revised plan contained a much more realistic view of the best audit coverage for the organization.

Audit Plan

The audit-planning process concludes with planning the actual engagement. If the entire planning process is robust and properly designed, it may start with a high-level aspiration to, for example:

> Formulate an opinion on the state of ERM and internal controls with a view to helping management make suitable improvements.

This may be applied throughout the auditors' work so that an audit engagement may have as its terms of reference words along the lines of:

> Review the adequacy of risk management and internal control in the application of security vetting for senior operations personnel in the Florida Area Office.

While a consulting engagement may appear as:

> Assist the project manager with designing a rapid response based risk assessment system to support the implementation of Project X.

The problem arises when audit engagements are planned with no reference to the long-term planning framework. In this instance, audit work can become fragmented and lead to no long-term advances for the organization. Moreover, the audits themselves can be demotivating for audit staff who have no overall sense of direction to help energize their performance. The CAE should evaluate the coverage of the proposed plan from two viewpoints:

Adequacy across organizational entities and

Inclusion of a variety of transaction and business-process types.

If the scope of the proposed audit plan is insufficient to enable the expression of assurance about the organization's risk management and control processes, the CAE should inform senior management and the board of the expected deficiency, its causes, and the probable consequences.[58]

RISK-BASED AUDIT PLANNING MODEL: FINAL

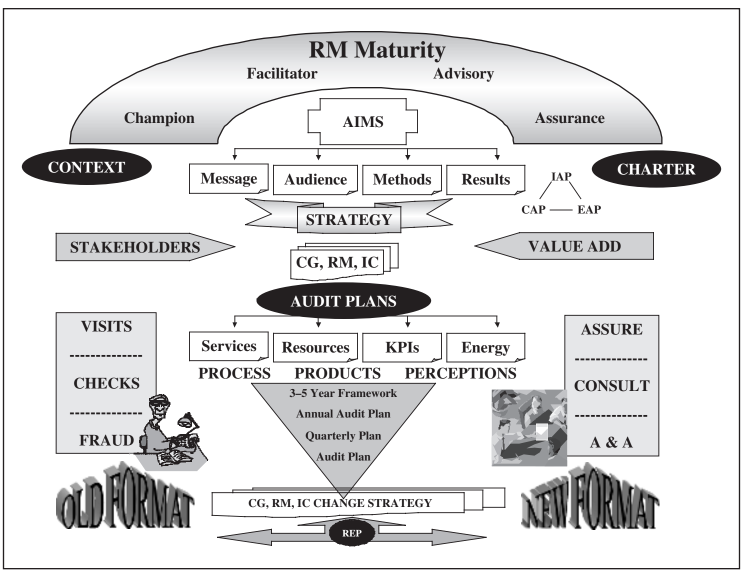
Our complete model is presented in Figure 1.8.

Each new aspect of the final model is described in the following paragraphs.

Visits, Checks, and Fraud

One element of our model relates to the dynamic nature of audit planning. Planning is not just about deciding which staff to assign to which audit. It is more about directing and motivating the audit resource through a jour-

Figure 1.8 The Complete Model



ney from where they are to where they need to be. It is about encouraging positive change for the better where the CAE has a vision for the future that becomes the force that binds the work team together around a common theme. One way to make progress is to focus on the new horizons for auditing and work out how to get closer to this horizon. Audit work used to comprise mostly of visiting remote establishments on behalf of head office management so as to judge whether the locals were behaving well and following head office procedures, the aim being to minimize fraud, abuse, errors, and general out-of-step work practices. This is what we have called the "Old Format" in our model.

CASE STUDY

Basic Risk Assessment

An old-fashioned audit team used a basic risk assessment to assign audit resources to the many local offices that were operated by the organization. The risk criteria applied to each local office were listed as follows:

- Size of workforce.
- Level of attractive portable stock items that could be pilfered by staff.
- Number of complaints from customers.
- Number of reported frauds and thefts.
- Level of errors in head office returns.
- Number of concerns raised by the head office finance department.

Offices that scored high using the above items were visited by the auditors each year, while the lower-scoring offices were seen less frequently.

Assure, Consult, Give Advice and Information (A&I)

Our model suggests that there is a "New Format" of audit work that revolves more around providing high-level assurance and consulting services to the board and audit committee, and across the organization. In this scenario, the members of the audit team are seen as the experts in governance, ERM, and internal control and spend some of their time giving advice and information (A&I) wherever this is needed within the organization. Risk-based audit planning supports risk-based audit work, and Paul Sobel has provided an idea of the most effective way of approaching audit work:

> A risk management based audit approach is the best, most comprehensive means of providing management with the assurances they desire;

that is that the key barriers to business success can be managed to an acceptable level.[59]

A case study brings home the main features of risk-management-based auditing.

CASE STUDY

Using Risk Issues

A forward-looking audit team developed a "risk issues" criteria for planning audit work. Using the corporate risk register, board risk management strategy, and discussions with top management, an issues document was published each year to set out the audit priorities for the ensuing year. The annual audit plan was derived from these discussions and made for a common sense approach to risk-based audit planning.

Old and New Formats

The move from the old format to the new format for audit work is built into our planning model and changes the auditor from being an inspector to an in-house governance, risk, and control expert. The differences in these two dimensions of style are summarized in Figure 1.9.

Figure 1.9 Old versus New Format

Old Style	New Style
Low-level audit process	Efficient risk focus to planning
Inflexible plans	Collaboration and change
Long-winded reviews	Embedded quality assurance
Many missed areas	Customer focus
Negative connotations	Positive value driven
Fragmented audit teams	Common themes driving audit work
Detailed reports	Automated executive reporting
CFO reporting line	Wider reporting line (to the audit committee)

CG, RM, and IC Change Strategy

We have already mentioned corporate governance (CG), risk management (RM), and internal control (IC) several times in the sense that these three concepts define the new-look auditor. We have suggested that a change strategy is embedded within the audit-planning process since most types of larger organizations are embarking on a journey to improve their governance arrangements to ensure they fit the heightened expectations from all parties who have a stake in the way an organization performs and behaves. Planning has little use if it is not based on setting clear goals and directing one's efforts toward these goals. Audit planning has little use if it does not revolve around a change strategy for encouraging better governance, robust risk management, and more reliable internal controls.

CASE STUDY

Using a Planning Forum

An audit team developed a current risk planning forum. Here, audit plans were completely reappraised each quarter to take on board all developments in the previous quarter. The audits that were completed during the year bore little resemblance to the annual audit plan set at the start of the year. The audit committee had agreed to a dynamic review mechanism whereby the annual audit plan was reapproved each quarter to reflect the various changes that would invariably have been put forward by the CAE. Most of these changes were in response to adjustments to the corporate risk register from new strategies, takeovers, and changes to operations and systems that were a feature of the way the organization worked. The above plans were held together by several common themes that incorporated the need to review and help improve the organization's ERM process and control disclosures infrastructure. Each proposed change to the audit plan was assessed against these criteria before being formally adopted.

Report

The final component of our first audit-planning model is reporting. Planning sets out what should be done and by whom, while after the work has been performed, it needs to be reported. It is always a good idea to build reporting into planning models as it is then possible to work backward, by defining what needs to be reported on by the audit department, and therefore what needs to be planned and performed to ensure that these reports can be delivered. Planning systems that do not incorporate the reporting process tend to be flawed. Management, the board, and/or the audit committee may well want to see several reports from the auditors, covering, for example:

- Assurances to the board regarding the adequacy and effectiveness of risk management arrangements and internal controls across the business.
- An account of the consulting work and ways in which the auditors have supported the development of governance, risk management, and controls.
- Information on high-risk aspects of the business where there is actual or potential for the corporate risk appetite to be exceeded.
- Information that can be used to gauge the success of internal audit in conjunction with the expectations of the audit committee and demands of professional auditing standards.
- Details of special investigations, systems failure, and breach of procedure that should be brought to the attention of the audit committee.
- Ways in which internal and external audit have cooperated to ensure best use of available resources.
- Any other information requested by the audit committee.

Another way to view audit reports is to consider what the CEO and board are obliged to report and how the auditors can input into these demands. IIA standards reinforce two main features of a good audit report:

> The CAE should evaluate the coverage of the proposed plan from two viewpoints: adequacy across organizational entities and inclusion of a variety of transaction and business-process types. If the scope of the proposed audit plan is insufficient to enable the expression of assurance about the organization's risk management and control processes, the CAE should inform senior management and the board of the expected deficiency, its causes, and the probable consequences.[60]

CASE STUDY

Controls Assurance Reporting

A firm of internal auditors won several audit contracts in the highly regulated heath service sector by focusing on assurance risk. The winning audit strategy presented to the audit committee was based on the following formula:

- Determine the exact regulatory disclosure requirement for the organizations in question.

Controls Assurance Reporting *(continued)*

- Isolate the assurance framework from various internal review teams and processes, along with control certifications from the management divisions that support the board's internal control disclosures.
- Review the assurance framework and determine which aspects were inadequate and in need of improvement.
- Place the above in an improvement program involving staff development, training programs, reporting tools, and self-assessment workshops.
- Indicate where the audit resource will be focused over the next year in terms of high-risk aspects of assurance reporting and areas where there is a need for further independent assurances to support the board's statements on internal control.

The above was then incorporated in an audit strategy that formed the basis of the successful bids for the contract for internal audit coverage of the organizations in question.

SUMMARY

It takes some effort to formulate good risk-based audit plans, and some audit teams are tempted to take short cuts in getting around planning so that audit staff can spend much more time on actual audit engagements. In our view, risk-based audit planning should be properly resourced, as it is a crucial part of auditors' work. One way to realize the benefits from risk-based audit planning is to go through the following five steps:

1. Understand the resources it takes to formulate a good, risk-based audit plan and make sure that audit managements are convinced of the benefits, including the need to tackle the risk of poorly focused plans.
2. Develop a clear policy on assurance and consulting work in the context of the state of maturity of ERM within the organization.
3. Understand and build in the concerns and views of key stakeholders when developing a risk-based planning process.
4. Ensure there is a strategy that sets a framework for risk-based audit planning designed to add value to the organization through the best application of audit resources.

5. Use risk-based audit planning to help drive new interpretations of audit's role, moving from traditional approaches to a balanced assurance and consulting service.

Note that Appendix A contains a checklist that can be used to assess the overall quality of risk-based audit planning.

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