
MANAGING AN INTERNAL AUDIT FUNCTION

The internal audit director needs to comply with the IIA's **Attribute Standards**, which say that the chief audit executive (CAE) is responsible for properly managing the department so that: (1) audit work fulfills the general purposes and responsibilities approved by senior management and accepted by the board, (2) resources of the internal auditing (IA) department are efficiently and effectively employed, and (3) audit work conforms to the **Standards**.

Internal Audit Charter

- Basic policy statement under which the internal auditing (IA) department operates.
- Establishes the IA department's position in the organization's hierarchy.
- IA department operates independently of all other departments in the organization.
- Describes the organizational status that the director of internal auditing should report to the chief executive officer (CEO) but have access to the board of directors. A dual reporting relationship exists here: reporting administratively to the president or CEO, and reporting functionally to the audit committee of the board of directors.
- Describes the purpose, authority, and responsibility of the IA department.

Mission or Purpose of the IA Department

- Review organization's activities to determine whether it is efficiently and effectively carrying out its function of controlling in accordance with management's instructions, policies, and procedures.
- Determine the adequacy and effectiveness of the system of internal controls in all areas of activity.
- Review the reliability and integrity of financial information and the means used to identify, measure, classify, and report such information.
- Review the means of safeguarding assets and, as appropriate, verify the existence of such assets.
- Appraise the economy and efficiency with which resources are employed, identify opportunities to improve operating performance, and recommend solutions to problems where appropriate.
- Review operations and plans to ascertain whether results are consistent with established objectives and goals, and whether the operations and plans are being carried out as intended.
- Coordinate audit efforts, where appropriate, with those of the external auditors.

Mission or Purpose of the IA Department (continued)

- Review the planning, design, development, implementation, and operation of relevant computer-based systems to determine whether (a) adequate controls are incorporated in the systems; (b) thorough system testing is performed at appropriate stages; (c) system documentation is complete and accurate; and (d) needs of the users are met.
- Conduct periodic audits of computer centers and make postinstallation evaluations of relevant data processing systems to determine whether those systems meet their intended purposes and objectives.
- Participate in the planning and performance of audits of acquisitions. Follow up to ensure the proper accomplishment of the audit objective.
- Report to those members of management who should be informed, or who should take corrective action, the results of audit examinations, the audit opinions formed, and the recommendations made.
- Evaluate the plans or actions taken to correct reported conditions for satisfactory disposition of audit findings. If corrective action is considered unsatisfactory, hold further discussions to achieve acceptable disposition.
- Provide adequate follow-up to ensure that proper corrective action is taken and that it is effective.

Authority

- The IA department will have full, free, and unrestricted access to records, personnel, and physical properties relevant to the performance of an audit.
- Internal auditors have neither authority over nor responsibility for the activities they audit.
- Audit director should have direct access to the audit committee since it tends to enhance IA's independence and objectivity.

Responsibility

The IA department accomplishes its purpose of assisting management by reviewing, examining, and evaluating activities, furnishing analyses and appraisals, and reporting findings and recommendations. This audit responsibility cannot relieve any operating manager of the requirement for ensuring proper control within his or her area of concern.

The IA department also has the responsibility to perform audit work with due professional care and with appropriate education, experience, certification, professional image and attitude, and personal integrity.

Planning

The director of internal auditing should establish plans to carry out the responsibilities of the internal auditing department. These plans should be consistent with the charter and with the goals for the organization. The planning process involves establishing goals, audit work schedules, staffing plans and financial budgets, and activity reports.

During audit planning, internal auditors should review all relevant information such as risk models/risk analysis, audit plans, audit assignments, and activity reports.

Risk Models/Risk Analysis

- Used in conjunction with development of long-range audit schedules.
- Judgment of the internal auditor and the results of quantitative risk assessment are the basis for audit planning work.
- Factors to be considered during risk analysis include:
 - Financial exposure
 - Potential loss of assets
 - Results of prior audits
 - Major operating changes
 - Damage to assets
 - Failure to comply with laws and regulations
- Skills available on the audit staff are not a risk factor since missing skills can be obtained elsewhere.
- The CAE should allocate the audit work schedule to managers based on risk analysis performed by auditors and skill analysis of the audit managers.

Audit Plan

The *audit plan* should include: a detailed schedule of areas to be audited during the coming year; an estimate of the time required for each audit, risk, exposure, and potential loss to the organization; and the approximate starting date for each audit.

Audit Assignment

Documentation needed to plan an audit assignment should include evidence that resources needed to complete the audit were considered. When the audit director makes audit assignments for inclusion in the work schedule, those assignments should be based on the relative risk of the auditable areas.

Criteria should be established when the audit resources are limited and a decision has to be made to choose between two operating departments for scheduling an audit. The most important criteria are: major changes in operations in one of the departments, more opportunities to achieve operating benefits in one of the departments than in the other, and when potential loss is significantly greater in one department than the other. Least important criteria are whether the audit staff has recently added an individual with experience in one of the auditable areas.

Activity Reports

Activity reports submitted periodically by the audit director to management and to the board should compare performance with audit work schedules. This requires comparing audits completed with audits planned.

Policies and Procedures

The CAE should provide written policies and procedures to guide the audit staff. An audit policies and procedures manual is most essential for guiding the audit staff in maintaining daily compliance with the department's standards of performance, and least important to audit quality control reviews, auditor position/job descriptions, and auditor performance appraisals.

Audit Manual

The need to issue formal manuals will largely depend on the size of the department. Any department with five or more staff members, or whose auditors work alone, should probably have one. The manual should address such things as administrative matters (e.g., progress reports, time and attendance, travel), adherence to the department's guidelines, relationships with auditees, auditing techniques, reporting audit results, and working paper standards (whether paper media, electronic media, or a combination).

Staff Meetings

- Staff meetings are conducted periodically to improve communications.
- Audit staff are afforded a venue where problems are discussed and receive updates regarding departmental policies.
- The CAE can address rumors affecting the audit department and the company.

Audit Reports

A report issued by an internal auditor should contain an expression of opinion when an opinion will improve communications with the reader of the report. Due professional care requires that the auditor's opinions be based on sufficient factual evidence that warrants the expression of the opinions. Due care does not require the performance of extensive audit examination. It calls for reasonable work.

The type of audit report (final, interim, or combination), the form of communication (oral, written, or combination), the type of audience to receive the audit report (internal management, external auditors, or combination), and the type of participants (by job title in the audit and the auditee department) to attend the entrance conference and the exit audit conference should be spelled out in the audit department policies and procedures manual.

An audit policy should require that final audit reports not be issued without a management response. However, when an audit with significant findings is complete except for management's response, the best alternative is to issue an *interim* report regarding the important issues noted. This is because time is of the essence here.

The final audit report should be reviewed, approved, and signed by the director of internal auditing or his designee. When illegal acts are being performed by several of the highest-ranking officers of the company, the audit report should be addressed to the audit committee of the board of directors.

Follow-up

The CAE should ensure follow-up of prior audit findings and recommendations to determine whether corrective action was taken and is achieving the desired results. If the auditor finds that no corrective action has been taken on a prior audit finding that is still valid, the auditor should determine whether management or the board has assumed the risk of not taking corrective action.

Personnel Management and Development

The CAE should establish a program for selecting and developing the human resources of the internal auditing department. A well-developed set of selection criteria is a key factor in the success of an audit department's human resource program.

Hiring

The audit staff should include members proficient in applying internal auditing standards, procedures, and techniques. When hiring an entry-level audit staff, the most likely predictors of an applicant's success as an auditor would be the ability to organize and express thoughts well; the least likely predictors would be: grade point average on college accounting courses; ability to fit well socially into a group; and the level of detail of knowledge of the company. When hiring an auditor, reasonable assurance should be obtained as to each prospective auditor's qualifications and proficiency. It should include obtaining college transcript(s), checking an applicant's references, and determining previous job experience.

Selection Criteria

The CAE should establish the evaluation criteria for the selection of new internal audit staff members. Criteria would be an appreciation of the fundamentals of accounting, an understanding of management principles, and the ability to recognize deviations from good business practices. Criteria would not include proficiency in computerized operations and the use of computers in auditing.

Performance Criteria

The CAE should establish guidelines for evaluating the performance of audit staff members: the evaluator should justify very high and very low evaluations because of their impact on the employee; evaluations should be made annually or more frequently to provide the employee with feedback about competence; and the first evaluation should be made shortly after commencing work to serve as an early guide to the new employee. But the evaluator should not use standard evaluation comments, because there are so many employees whose performance is completely satisfactory. The performance appraisal system for evaluating an auditor should include specific accomplishments directly related to the performance of the audit program.

Continuing Education

The CAE is responsible for establishing continuing education and training opportunities to develop the human resources of the audit department. The main purpose of audit department training is to achieve both individual and departmental goals in training.

External Auditors

The CAE should coordinate internal and external audit efforts to minimize duplication of audit work and to increase the effectiveness of audit work.

Quality Assurance

The CAE should establish and maintain a quality assurance program to evaluate the operations of the internal auditing department. The standard calls for three elements for the quality assurance program: supervision, internal reviews, and external reviews. The audit department should have periodic quality assurance reviews. Accomplishing the intended results and demonstrating consistent quality are also part of the quality assurance task.

Postaudit Quality Review

The postaudit quality review provides top managers with an independent assessment of the extent to which the audit organization complies with professional standards and its own policies and procedures.

Reviewing individual assignments provides valuable feedback to managers on how well-selected auditable units consistently achieve the expected quality. The number and type of assignments selected for testing should provide a reasonable basis for making this assessment.

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

Internal audit activities are performed in diverse legal and cultural environments; within organizations that vary in purpose, size, complexity, and structure; and by persons within or outside the organization. While differences may affect the practice of internal auditing in each environment, compliance with the *International Standards for the Professional Practice of Internal Auditing* is essential if the responsibilities of internal auditors are to be met. If internal auditors are prohibited by laws or regulations from complying with certain parts of the *Standards*, they should comply with all other parts of the *Standards* and make appropriate disclosures.

The four purposes of the *Standards* are to:

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

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

The *Standards* consist of *Attribute Standards*, *Performance Standards*, and *Implementation Standards*. The *Attribute Standards* address the characteristics of organizations and parties performing internal audit activities. The *Performance Standards* describe the nature of internal audit activities and provide quality criteria against which the performance of these services can be evaluated. While the *Attribute and Performance Standards* apply to all internal audit services, the *Implementation Standards* apply to specific types of engagements.

There is one set of *Attribute and Performance Standards*; however, there are multiple sets of *Implementation Standards*: a set for each of the major types of internal audit activity. The *Implementation Standards* have been established for assurance (A) and consulting (C) activities.

The *Standards* are part of the Professional Practices Framework. The Professional Practices Framework includes the Definition of Internal Auditing, the Code of Ethics, the *Standards*, and other guidance. Guidance regarding how the *Standards* might be applied is included in Practice Advisories that are issued by the Professional Issues Committee.

IIA'S ATTRIBUTE STANDARDS

Purpose, Authority, and Responsibility

- Formally defined in a charter, consistent with the *Standards*, and approved by the board (IIA Standard 1000).
- The nature of assurance services provided to the organization should be defined in the audit charter. If assurances are to be provided to parties outside the organization, the nature of these assurances should also be defined in the charter (IIA Standard 1000.A1).
- The nature of consulting services should be defined in the audit charter (IIA Standard 1000.C1).

Independence and Objectivity

Organizational Independence

- The CAE should report to a level within the organization that allows the internal audit activity to fulfill its responsibilities (IIA Standard 1110).
- The internal audit activity should be free from interference in determining the scope of internal auditing, performing work, and communicating results (IIA Standard 1110.A1).

Individual Objectivity

- Internal auditors should have an impartial, unbiased attitude and avoid conflicts of interest (IIA Standard 1120).

Impairments to Independence or Objectivity

- If independence or objectivity is impaired in fact or appearance, the details of the impairment should be disclosed to appropriate parties. The nature of the disclosure will depend on the impairment (IIA Standard 1130).
- Internal auditors should refrain from assessing specific operations for which they were previously responsible. Objectivity is presumed to be impaired if an **internal** auditor provides assurance services for an activity for which the **internal** auditor had responsibility within the previous year (IIA Standard 1130.A1).
- Assurance engagements for functions over which the CAE has responsibility should be overseen by a party outside the internal audit activity (IIA Standard 1130.A2).
- Internal auditors may provide consulting services relating to operations for which they had previous responsibilities (IIA Standard 1130.C1).
- If internal auditors have potential impairments to independence or objectivity relating to proposed consulting services, disclosure should be made to the engagement client prior to accepting the engagement (IIA Standard 1130.C2).

Proficiency and Due Professional Care

Proficiency

Internal auditors should possess the knowledge, skills, and other competencies needed to perform their individual responsibilities. The internal audit activity collectively should possess or obtain the knowledge, skills, and other competencies needed to perform its responsibilities (IIA Standard 1210).

The CAE should obtain competent advice and assistance if the internal audit staff lacks the knowledge, skills, or other competencies needed to perform all or part of the engagement (IIA Standard 1210.A1).

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 investigating fraud (IIA Standard 1210.A2).

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

The CAE should decline the consulting engagement or obtain competent advice and assistance if the internal audit staff lacks the knowledge, skills, or other competencies needed to perform all or part of the engagement (IIA Standard 1210.C1).

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 (IIA Standard 1220).

The internal auditor should exercise due professional care (IIA Standard 1220.A1) by considering the

- Extent of work needed to achieve the engagement's objectives
- Relative complexity, materiality, or significance of matters to which assurance procedures are applied
- Adequacy and effectiveness of risk management, control, and governance processes
- Probability of significant errors, irregularities, or noncompliance
- Cost of assurance in relation to potential benefits

In exercising due professional care, the internal auditor should consider the use of computer-assisted audit tools and other data analysis techniques (IIA Standard 1220.A2).

The internal auditor should be alert to the significant risks that might affect objectives, operations, or resources. However, assurance procedures alone, even when performed with due professional care, do not guarantee that all significant risks will be identified (IIA Standard 1220.A3).

Due Professional Care (continued)

The internal auditor should exercise due professional care during a consulting engagement (IIA Standard 1220.C1) by considering the

- Needs and expectations of clients, including the nature, timing, and communication of engagement results
- Relative complexity and extent of work needed to achieve the engagement's objectives
- Cost of the consulting engagement in relation to potential benefits

Continuing Professional Development

Internal auditors should enhance their knowledge, skills, and other competencies through continuing professional development (IIA Standard 1230).

Quality Assurance and Improvement Program

The CAE should develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity and continuously monitors its effectiveness. *Each part of the program* should be designed to help the internal auditing activity add value and improve the organization's operations and to provide assurance that the internal audit activity is in conformity with the *Standards* and the Code of Ethics:

- Quality Program Assessments (IIA Standard 1310)
- Internal Assessments (IIA Standard 1311)
- External Assessments (IIA Standard 1312)
- Reporting on the Quality Program (IIA Standard 1320)
- Use of "Conducted in Accordance with the Standards" (IIA Standard 1330)
- Disclosure of Noncompliance (IIA Standard 1340)

IIA'S CODE OF ETHICS

The IIA's Code of Ethics promotes an ethical culture in the profession of internal auditing.

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

The IIA's Code of Ethics extends beyond the definition of internal auditing to include two essential components: (1) Principles, and (2) Rules of Conduct.

The Code of Ethics together with the IIA's Professional Practices Framework and other relevant Institute pronouncements provide guidance to internal auditors serving others. "Internal auditors" refers to Institute members, recipients of or candidates for IIA professional certifications, and those who provide internal auditing services within the definition of internal auditing.

Applicability and Enforcement

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

Principles and Rules of Conduct

- Integrity
- Objectivity
- Confidentiality
- Competency