

The Internal Audit Process:

Planning the engagement

AUI3701

Department
of Auditing

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STUDY OVERVIEW

INTRODUCTION TO THIS MODULE: THE INTERNAL AUDIT PROCESS – PLANNING AN INTERNAL AUDIT

Dwight D. Eisenhower once remarked: *“In preparing for battle I have always found that plans are useless, but planning is indispensable.”* For internal auditors, planning is so important that this whole module as well as a large part of AUI3704 has been devoted to its discussion.

The International Standards for the Professional Practice of Internal Auditing (Standards) distinguish between two major types of planning conducted by internal auditors.

1. Standard 2010–1 Planning:

The chief audit executive must establish risk-based plans to determine the priorities of the internal audit activity, consistent with organisational goals.

According to Standard 2010.A1, the internal audit activity’s plan of engagements (that results from the planning recommended in Standard 2010–1) must be based on a documented risk assessment, undertaken at least annually, and the input of senior management and the board must be considered in this process.

This type of planning therefore results in a plan of audit engagements which is based on a risk assessment of the whole organisation and which is approved by the board.

2. Standard 2200 Engagement Planning:

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












Thus, for each engagement planned according to Standard 2010–1, planning should be conducted according to Standard 2200.

In this module we focus on the planning of the audit engagement, according to Standard 2200. Standard 2010–1 is discussed in Module AUI3704.

THE ICONS OF ACTIVITIES USED IN YOUR STUDY MATERIAL

Each learning unit contains various activities which you should perform. The study activities, for example, refer you to the study material in the study guide and tutorial letters which you are required to study; the doing and thinking activities require you to perform certain actions and to answer certain questions.

The icons that will be used in this study guide and tutorial letter are listed below, together with a description of what each of them means:

Icon	Description
	Key concepts. The Key concepts icon draws your attention to certain keywords or concepts that you will come across in the topic or learning unit.
	Learning outcomes. The Learning outcomes indicate which aspects of the particular topic or learning units you have to master and demonstrate that you have mastered them.
	Mind map. Mind maps are provided to help you to see the relationship between various parts of the learning material.
	Study. The Study icon indicates which sections of the prescribed book or the study guide you need to study and internalise.
	Read. The Read icon will direct you to read certain sections of the prescribed book for background information.
	Activity. The Activity icon refers to activities that you must do in order to develop a deeper understanding of the learning material.
	Reflection. The Reflection icon requires you to reflect on the important issues or problems dealt within the learning unit.
	Assessment. When you see the Assessment icon you will be required to test your knowledge, understanding and application of the material you have just studied.
	Feedback. The Feedback icon indicates that you will receive feedback on your answers to the self-assessment activities.
	Multimedia. The Multimedia icon indicates that you have to refer to any audio, video, or DVD material that may be included in your study material.
	Time-out. The Time-out icon indicates that you should take a rest because you have reached the end of a learning unit or topic.

STUDY SOURCES

The study material for this module comprises the discussions and explanations contained in this study guide and tutorial letters, the study material issued and prescribed for Module AUE2602: *Corporate Governance in Accounting*, as well as those contained in the following prescribed books:

- Reding, KF, Sobel, PJ, Anderson, UL, Head, MJ, Ramamoorti, S, Slamasick, M & Riddle, C. *Internal auditing: Assurance & advisory services*. The Institute of Internal Auditors Research Foundation. (3rd edition) (Referred to in the text as **Reding et al**).
- Jackson, RDC & Stent, WJ. *Auditing notes for South African students*. Durban: LexisNexis Butterworths. (latest edition) (Referred to in the text as **Jackson & Stent**).
- *Auditing legislation and standards*. LexisNexis Butterworths. South Africa.

PART A

Planning an internal audit according to the International Professional Practices Framework (IPPF)

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TOPIC 1

International Professional Practices Framework (IPPF) requirements pertaining to the planning of an internal audit

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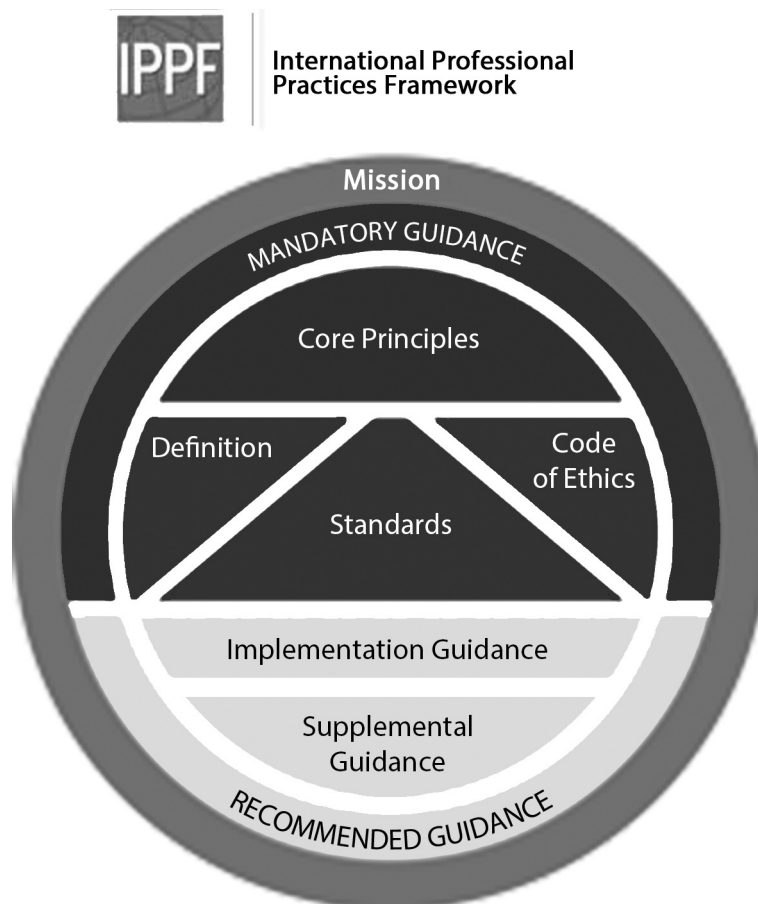
INTRODUCTION AND PURPOSE OF THE TOPIC

The aim of the International Professional Practices Framework (IPPF), developed and published by the Institute of Internal Auditors (IIA) is to ensure professionalism and consistency in the practice of internal auditing. Internal auditors demonstrate their professionalism by adhering to the IPPF.

The IPPF is the only globally recognised guidance for internal auditors worldwide. It provides “**mandatory**” and “**strongly recommended**” guidance to all members of the Institute of Internal Auditors (IIA) and recipients of any IIA professional certifications, such as the Certified Internal Auditor (CIA) qualification.

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

FIGURE 11
The International Professional Practices Framework (IPPF)



Mandatory guidance	Strongly recommended guidance
<ul style="list-style-type: none"> “Conformance with the principles set forth in mandatory guidance is required and essential for the professional practice of internal auditing” (IPPF, 2011). 	<ul style="list-style-type: none"> “Strongly recommended guidance is endorsed by the IIA through a formal approval process. It describes practices for effective implementation of the IIA’s definition of internal auditing, Code of Ethics, and Standards” (IPPF, 2011).

Mandatory guidance is provided through the Definition, **Core Principles for the Professional Practice of Internal Auditing**, the **Code of Ethics**, and **Standards**, as well as all recommended guidance. **Strongly recommended** guidance is provided through the practice advisories (Implementation guidance) and practice guides (Supplemental guidance).

The purpose of this topic is to guide you in familiarising yourself with the requirements and guidance contained in the IPPF that have an impact on the **planning** of an internal audit so that you can become proficient in adhering to the IPPF when planning internal audit engagements.

As you proceed through the study guide, you will frequently be requested to reflect on the knowledge you have acquired of relevant IPPF requirements and guidance while studying this topic.

Module AUI2601 guided you in a detailed study of the IPPF. You should, therefore, be familiar with all the components of the IPPF and you should be aware of its application in the practice of internal auditing. To refresh your knowledge of the IPPF, you may refer back to your AUI2601 study guide and/or *Reding et al*, chapter 2.



LEARNING OUTCOMES

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

- demonstrate a solid knowledge and understanding of the provisions of the International Professional Practices Framework's (IPPF) which may impact on the way internal auditors plan internal audit engagements
 - apply the guidance provided in the International Professional Practices Framework (IPPF) when planning internal audit engagements
-

In this topic you will study the requirements and guidance of the IPPF relevant to the planning of an internal audit engagement. We will, therefore, emphasise the guidance that specifically relates to the planning of engagements.

Learning unit 1

Adhering to the IIA code of ethics when planning an internal audit engagement

The IIA Code of Ethics firstly identifies four *principles* that are relevant to the profession and practice of internal auditing. These principles, *integrity*, *objectivity*, *confidentiality* and *competency*, must serve as the cornerstones of all internal audit activity.

Secondly, for each of the principles identified above, the IIA Code of Ethics stipulates certain *rules of conduct* which describe norms of behaviour expected of internal auditors. These rules are an aid to interpreting the principles into practical applications and are intended to guide the ethical conduct of internal auditors.



STUDY

Study the *IIA Code of Ethics* in *Reding et al*: Appendix A.

Study the discussion of the IIA Code of Ethics in *Reding et al*, chapter 2.



KEY CONCEPTS

The key concepts to focus on when studying the IIA Code of Ethics are

- the principles
- the rules of conduct

The key concept to focus on when studying this learning unit is on how to conform to the Code of Ethics when planning an internal audit engagement.

The following diagram describes examples of unacceptable (✗) and acceptable (✓) conduct when **planning an internal audit engagement** and aims to explain how the code of ethics can be used to guide acceptable internal auditing practice.

Principle	Rules of conduct (condensed)	✗	✓
Integrity	Perform work with honesty, diligence and responsibility	The internal auditors base their audit of credit sales on a systems description that was compiled five years ago.	The internal auditors perform a preliminary review during which they confirm the accuracy of the systems description for credit sales before they decide on the tests to be performed.
	Observe the law and make disclosures expected by law or the profession	The audit file supporting an audit engagement conducted on manufacturing processes does not contain evidence of the planning being conducted.	The audit working paper file contains a planning document setting out the engagement's objectives, scope, timing and resource allocations.

Principle	Rules of conduct (condensed)	✗	✓
	Not be part of illegal activity or acts discreditable to the profession or the organisation	During an assurance audit of procurement activities, the auditor adheres to a request from the procurement manager not to include purchases made from a certain supplier in the audit.	Realising that a request by the procurement manager to exclude purchases made from certain suppliers in the audit may be a scope limitation and may point to irregularities that may have taken place, the auditor refers the manager's request to internal audit management for consideration and considers it a red flag for possible fraud.
	Respect and contribute to legitimate and ethical objectives of the organisation	Analytical procedures conducted during the preliminary review indicate that payments to suppliers are being delayed. Knowing that the company is experiencing cash-flow problems, the auditor decides to ignore the delayed payments in the planning of the engagement.	Analytical procedures conducted during the preliminary review indicate that payments to suppliers are being delayed. The internal auditor incorporates procedures into his engagement audit plan to establish the reasons for the delayed payments.
Objectivity	Not participate in any activity or relationship which may impair unbiased assessment or which is in conflict with the interests of the organisation	Some of the work on an audit engagement in the procurement section is assigned to an internal auditor whose father is heading the section.	Internal auditors are requested to disclose any relationships that may impair unbiased assessment or which are in conflict with the interests of the organisation and conflicting assignments of audit staff are avoided.
	Not accept anything which may impair professional judgement	The planning of an organisation's retail outlet in the North West Province is scheduled to fall over a long weekend as the senior in charge of the audit loves hunting and always gets an opportunity to hunt on the branch manager's farm during one of the weekends falling within the audit.	An internal auditor rejects an offer to go hunting with the branch manager on his farm knowing that this could be seen as an impairment of his objectivity when conducting the audit at the branch.
	Disclose all known material facts that, if not disclosed, may distort the reporting of activities under review	Since everyone in the organisation is aware of the IT department's inability to arrange suitable back-up facilities for the financial systems of the organisation, the internal auditor	The auditor includes an audit procedure in the planning of the IT audit to enquire about the status of back-up facilities. He also places a reminder on the file to report on the status of the back-up facilities of the organisation.

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Principle	Rules of conduct (condensed)	✗	✓
		excludes this from the planning of the IT audit.	
Confidentiality	Be prudent in the use and protection of information acquired	During the planning stage of the engagement, an auditor becomes suspicious that fraud is being committed. She discusses her finding and the possibility of fraud with her colleague in the canteen over lunch.	During the planning stage of the engagement, an auditor becomes suspicious that fraud is being committed. She discusses her finding and the possibility of fraud with the internal audit manager in his office.
	Not use any information for personal gain, contrary to the law or detrimental to the organisation	During initial discussions with a director of a motor vehicle dealer, the auditor notices a confidential file on the manager's desk containing details of the launch of a new model range in a week's time. While the director is attending to an urgent matter in another office, the auditor opens the file, takes a couple of photographs of the brochures inside the file and sends it to his friends by sms.	During initial discussions with a director of a motor vehicle dealer, the auditor notices a confidential file on the manager's desk containing details of the launch of a new model range in a week's time. While the director is attending to an urgent matter in another office, the auditor respects the confidentiality of the file while awaiting the director's return.
Competency	Engage only in those services for which they have the necessary knowledge, skills, and experience	During the planning of an audit of engineering projects, the auditor is informed that the company's first project for a mining company is amongst the projects completed for the period to be audited. The auditor excludes the project from the audit, since he has no knowledge or experience of the mining sector.	During the planning of an audit of engineering projects, the auditor is informed that the company's first project for a mining company is amongst the projects completed for the period to be audited. The auditor includes the audit in the audit scope and makes provision in his planning for consulting with mining sector specialists appointed by his company's external auditing firm during the audit.
	Perform internal audit services in accordance with the Standards	An engagement is planned without any consideration being given to the risk assessment conducted for the department.	During the planning of an engagement, the auditor considers the significant risks to the activity, its objectives, resources and operations and the means by which the potential impact of risk is kept at an acceptable level.

Principle	Rules of conduct (condensed)	✗	✓
	Continually improve proficiency and the effectiveness and quality of services	During the planning of a consulting engagement, the auditor spends limited time discussing the audit with the client.	During the planning of a consulting engagement, the auditor spends adequate time with the client to determine the objectives, scope, respective responsibilities, and other client expectations. He also documents his understanding of the engagement and has it signed by the client.

To clearly illustrate unacceptable and acceptable behaviour, we have simplified the examples in the diagram above. In practice, it sometimes becomes difficult to distinguish between acceptable and unacceptable behaviour. When in doubt, inexperienced auditors should seek advice from internal audit management and/or the chief internal auditor. Internal audit executives may have to seek technical advice from the Institute of Internal Auditors or from legal advisors. Of essence, however, is an in-depth knowledge and conceptualisation of the principles and rules of conduct and continuously integrating them into any aspect of internal auditing practice.



ACTIVITY 1.1

Answer the multiple-choice questions below.

- Which one of the following alternatives would constitute a violation of the Institute of Internal Auditors' (IIA's) code of ethics?
 - Mr Grey, a senior internal auditor, discovered financial fraud while planning the audit of the revenue and receipt business process. The financial statements were adjusted to properly reflect the loss associated with the fraud. Mr Grey discussed the fraud with the external auditors upon the commencement of the annual external audit.
 - Mr Anatomy accepted an assignment to plan the audit of the electronics manufacturing division. Mr Anatomy has recently joined the internal audit department. He previously worked as a senior auditor for an external auditing firm and has audited many electronics companies during the past two years.
 - Ms Wives is content with her career as an internal auditor and has come to consider it as a regular nine-to-five job. She has not engaged in continuing professional education or other activities to improve her effectiveness during the last three years. However, she feels that she is delivering the same quality of work that she has always delivered.
 - Ms Desperate has been assigned to lead an internal audit of the warehousing function six months from now. Ms Desperate has no expertise in that area, but decides to accept the assignment. She has signed up for continuing education courses in warehousing, which she will complete before her assignment is due.
- Which one of the following actions will *not* affect an internal auditor's independence or objectivity?
 - planning an audit assignment at a division for which the internal auditor will soon be responsible as a result of his/her promotion
 - reducing the scope of an audit engagement because of budget restrictions
 - leading or coordinating a task force that develops control procedures for a new distribution system

- (d) planning the auditing of a purchasing agent's contract drafts prior to their execution



FEEDBACK

Question 1

Option (c) is correct as this is in violation of the competency principle. The rules of conduct regarding competency state that internal auditors must continually improve their proficiency and the effectiveness and quality of their services.

Options (a), (b) and (d) are accepted behaviour and therefore are not in violation of the Institute of Internal Auditors' Code of Ethics.

Question 2

This question tested your understanding of the objectivity principle in the Code of Ethics. You were required to select the statement which had the **least** influence on objectivity.

Option (b) is correct as the internal auditor's training in communication skills has no impact on objectivity.

Option (a) is incorrect, as this does have an influence on objectivity.

Option (c) is incorrect, as this has no bearing on the objectivity of internal auditors.

Option (d) is incorrect, as this has the most influence on objectivity.

The four principles of the Code of Ethics are *integrity*, *objectivity*, *confidentiality* and *competency*. Internal auditors should strive to comply with these principles to earn the trust of those who rely on their services.



Learning unit 2

International Standards for the Professional Practice of Internal Auditing (standards) impacting on the planning of an internal audit engagement

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2.1 Introduction

As discussed in Module AUI2601 and *Reding et al* chapter 2, the International Standards for the Professional Practice of Internal Auditing (Standards) outline the basic principles of internal auditing practice. Conformance with the Standards is essential in meeting the responsibilities of internal auditors and the internal audit activity. The Standards also provide the basis for measuring the performance and value added by the internal audit activity.



STUDY

Study the following International Standards for the Practice of Internal Auditing (*Standards*) included in *Auditing Legislation and Standards* or in *Reding et al* as appendix B. (You may also access the Standards on the IIA's international website at www.theiia.org.)

ATTRIBUTE STANDARDS

- 1000 – Purpose, Authority and Responsibility
- 1100 – Independence and Objectivity
- 1200 – Proficiency and Due Professional Care

PERFORMANCE STANDARDS

- 2010 – Planning
 - 2100 – Nature of Work
 - 2200 – Engagement Planning
 - 2300 – Performing the Engagement
 - 2400 – Communicating Results
 - 2500 – Monitoring Progress
 - 2600 – Communicating Acceptance of Risks
-



KEY CONCEPTS

The key concepts to focus on when studying the Attribute Standards are

- the internal audit charter
- assurance and consulting services

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- organisational independence
- individual objectivity
- proficiency
- due professional care
- ongoing monitoring
- using the statement: "Conforms with the International Standards for the Professional Practice of Internal Auditing"

The key concepts to focus on when studying the Performance Standards are

- risk based planning
- internal audit activity's plan of engagements
- coordination of activities with assurance providers
- using a systematic and disciplined approach
- assessing and improving governance processes
- evaluating and improving risk management processes
- assisting in maintaining effective controls
- engagement planning
- establishing engagement objectives
- engagement scope
- resource allocation
- work programmes
- documenting information
- supervision
- criteria for communication
- quality of communication
- conducting in accordance with the Standards

The key concept to focus on when studying this learning unit is on how to conform to the Standards when planning an internal auditing engagement.

The following table explains how the Standards may be interpreted/applied during this stage of the audit engagement:

Attribute standards

Concept	Standard	Interpretation/Implementation
The internal audit <u>charter</u>	1000	<ul style="list-style-type: none"> • The internal audit charter formally defines the purpose, authority and responsibility of the internal audit activity. • The nature of assurance services and the nature of consulting services provided to the organisation must be defined in the internal audit charter. (For a better understanding of the difference between assurance and consulting services, read the section entitled <i>Assurance and consulting services</i> in <i>Reding et al</i>, chapter 2.) • If tests of controls result in assurances to be provided to parties outside the organisation, the charter must define the nature of these assurances.
Organisational <u>independence</u>	1110A1	<ul style="list-style-type: none"> • When planning internal audit engagements, the internal audit activity must be free from interference in determining the scope of such engagements, the procedures applied during the engagement and communicating the results of the engagement.
Individual <u>objectivity</u>	1120	<ul style="list-style-type: none"> • An internal auditor should have no conflicting interests that may influence or may appear to be influencing his

Concept	Standard	Interpretation/Implementation
		<p>or her ability to plan an internal audit engagement objectively.</p> <ul style="list-style-type: none"> Internal auditors assigned to an engagement should have an impartial, unbiased attitude and assignment of staff to internal audit engagements should avoid any conflict of interest.
Impairment of independence and/or objectivity	1130	<ul style="list-style-type: none"> If independence or objectivity is impaired in fact or appearance, the details of the impairment (e.g. conflict of interest, scope limitation, restriction of access to records, personnel and properties and resource limitations) must be disclosed to appropriate parties. Internal auditors must refrain from performing tests of controls as part of assurance engagements in areas they were previously responsible for – at least for one year.
<u>Proficiency</u>	1210	<ul style="list-style-type: none"> Internal audit activities and individual internal auditors involved in the planning of an internal audit engagement should possess the knowledge, skills and other competencies needed to conduct such planning. The individual internal auditors assigned to an internal audit engagement should collectively possess or obtain the knowledge, skills and the competencies needed to perform the engagement. Practice Advisory 1210-1 elaborates on the proficiency requirements for internal auditors. Where an internal audit activity lacks competencies to conduct a specific assurance engagement, the competencies should be obtained elsewhere. Internal auditors must have sufficient knowledge to evaluate the risk of fraud when planning an internal audit engagement. Internal auditors should have sufficient knowledge of key information technology risks and controls and available technology-based audit techniques to perform their assigned work.
<u>Due professional care</u>	1220	<ul style="list-style-type: none"> When planning an engagement, the internal auditor should exercise due professional care by considering the <ul style="list-style-type: none"> – extent of work needed to achieve the engagement's objectives – relative complexity, materiality or significance of matters to which testing procedures are applied – adequacy and effectiveness of governance, risk management and control processes – probability of significant errors, fraud or noncompliance – cost of controls/assurance provided in relation to the potential benefit When planning the engagement, the internal auditor must consider the use of technology-based audit and other data analysis techniques.

TOPIC 1: INTERNATIONAL PROFESSIONAL PRACTICES FRAMEWORK (IPPF) REQUIREMENTS
PERTAINING TO THE PLANNING OF AN INTERNAL AUDIT

Concept	Standard	Interpretation/Implementation
		<ul style="list-style-type: none"> Internal auditors must be alert to potential risks that might affect objectives, operations or resources when planning the internal audit engagement. When planning a consulting engagement, internal auditors should consider the <ul style="list-style-type: none"> 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
Ongoing monitoring	1311	The planning of internal audit engagements should be subjected to ongoing monitoring, which should form an integral part of the day-to-day supervision, review, and measurement of the internal audit activity.
Using the statement: <u>"Conforms with the International Standards for the Professional Practice of Internal Auditing"</u>	1340	When reporting on an internal audit engagement, the auditor may only state that the audit was performed in conformance with the Standards if the results of the quality assurance and improvement programme support this statement.

Performance standards

Concept	Standard	Interpretation/Implementation
<u>Risk-based</u> planning Internal audit activity's <u>plan of engagements</u>	2010	<p>Engagement planning should form part of the internal audit activity's risk-based plans. In developing a risk-based plan for the internal audit activity, the CAE takes into account the organisation's risk management framework, including using risk appetite levels set by management for the different activities or parts of the organisation.</p> <p>The planning conducted by the CAE results in a plan of engagements. The internal audit activity's plan of engagements must be based on a documented risk assessment, undertaken at least annually.</p> <p>The input of senior management and the board must be considered in this process.</p>
<u>Coordination</u> of activities with other assurance providers	2050	The internal auditors should share information with regard to the planning of internal audits and coordinate activities with other internal and external assurance providers and consulting services to ensure proper coverage and minimised duplication of efforts.
Using a <u>systematic and disciplined approach</u>	2100	Planning an internal audit engagement involves the design of a systematic and disciplined approach to improve governance, risk management and control processes.

Concept	Standard	Interpretation/Implementation
Assessing and improving <u>governance processes</u>	2110	<p>The internal audit activity should plan internal audit engagements to assess and make recommendations that will improve the organisation's governance processes. In doing this, the internal audit activity aims to –</p> <ul style="list-style-type: none"> • promote appropriate ethics and values within the organisation • ensure effective organisational performance management and accountability • communicate risk and control information to appropriate areas of the organisation and • coordinate the activities of and communicate information among the board, external and internal auditors and management
Evaluating and improving <u>risk management processes</u>	2120	<p>The internal audit function will plan internal audit engagements to assess and make recommendations that will improve the organisation's risk management process. In performing these tests, the internal audit activity will assess whether or not the –</p> <ul style="list-style-type: none"> • organisational objectives support and are aligned with the organisation's mission • significant risks are identified and assessed • appropriate risk responses are selected that align risks with the organisation's risk appetite • relevant risk information is captured and communicated in a timely manner across the organisation, enabling staff, management and the board to carry out their responsibilities
Assist in maintaining <u>effective controls</u>	2130	<p>Where deemed necessary the internal audit function will plan internal audit engagements to assist the organisation in maintaining effective controls by evaluating their effectiveness and efficiency and by promoting continuous improvement. To this effect, the internal audit activity evaluates risk exposures and evaluates the design adequacy and operating effectiveness of controls regarding the –</p> <ul style="list-style-type: none"> • reliability and integrity of financial and operational information • effectiveness and efficiency of operations • safeguarding of assets • compliance with laws, regulations, and contracts
Engagement <u>planning</u>	2200	<p>A plan should be documented for every internal audit engagement. The plan should include the engagement's objectives, scope, timing, and resource allocations. In planning such an engagement the auditor should consider</p> <ul style="list-style-type: none"> • the objectives of the activity being reviewed and the means by which the activity controls its performance • the significant risks to the activity, its objectives, resources and operations and the means by which the potential impact of risk is kept to an acceptable level

TOPIC 1: INTERNATIONAL PROFESSIONAL PRACTICES FRAMEWORK (IPPF) REQUIREMENTS
PERTAINING TO THE PLANNING OF AN INTERNAL AUDIT

Concept	Standard	Interpretation/Implementation
		<ul style="list-style-type: none"> the adequacy and effectiveness of the activity's risk management and control processes compared to a relevant control framework or model the opportunities for making significant improvements to the activity's risk management and control processes <p>When planning an engagement for parties outside the organisation, internal auditors must establish a written understanding with them about objectives, scope, respective responsibilities, and other expectations, including restrictions on distribution of the results of the engagement and access to engagement records.</p>
Establishing engagement <u>objectives</u>	2210	<p>Objectives must be established for every engagement.</p> <p>Internal auditors must conduct a preliminary assessment of the risks relevant to the activity under review and engagement objectives must reflect the results of this assessment.</p> <p>Internal auditors must consider the probability of significant errors, fraud, noncompliance and other exposures when developing the engagement objectives.</p> <p>Adequate criteria are needed to evaluate controls. Internal auditors must ascertain the extent to which management has established adequate criteria to determine whether objectives and goals have been accomplished.</p> <p>If adequate, internal auditors must use such criteria in their evaluation. If inadequate, internal auditors must work with management to develop appropriate evaluation criteria.</p> <p>Consulting engagement objectives must address governance, risk management and control processes to the extent agreed upon with the client.</p> <p>Consulting engagement objectives must be consistent with the organisation's values, strategies, and objectives.</p>
Engagement <u>scope</u>	2220	<p>The established scope of an engagement must be sufficient to satisfy the objectives of the engagement.</p> <p>The scope of the engagement must include consideration of relevant systems, records, personnel and physical properties, including those under the control of third parties.</p> <p>If significant consulting opportunities arise during an assurance engagement, a specific written understanding as to the objectives, scope, respective responsibilities and other expectations should be reached and the result of the consulting engagement communicated in accordance with consulting standards.</p> <p>The scope of a consulting engagement must be sufficient to address the agreed objectives. If internal auditors develop reservations about the scope during the engagement, these reservations must be discussed with the client to determine whether to continue with the engagement.</p>

Concept	Standard	Interpretation/Implementation
		During consulting engagements, internal auditors should be alert to significant control issues.
<u>Resource allocation</u>	2230	Internal auditors must determine appropriate and sufficient resources to achieve engagement objectives based on an evaluation of the nature and complexity of each engagement, time constraints, and available resources.
<u>Work programmes</u>	2240	<p>Internal auditors must develop and document work programmes that will achieve the engagement objectives.</p> <p>Work programmes must include the procedures for identifying, analysing, evaluating and documenting information during the engagement.</p> <p>The work programme must be approved prior to its implementation and any adjustments approved promptly.</p> <p>Work programmes for consulting engagements may vary in form and content depending upon the nature of the engagement.</p>
<u>Documenting information</u>	2330	Relevant information regarding the planning of the engagement should be documented to support the conclusions reached.
Criteria for communicating	2410	Communications must include the engagement's objectives and scope as well as applicable conclusions, recommendations and action plans.
Quality of communication	2420	Communications must be accurate, objective, clear, concise, constructive, complete and timely.
"Conducted in accordance with the Standards"	2430	Internal auditors may report that their engagements are conducted in conformance with the Standards only if the results of the quality assurance and improvement programme support the statement.



ACTIVITY 2.1

Answer the following multiple-choice questions:

- According to the Standards, supervision of an audit assignment should include ...
 - determining that audit working papers adequately support the audit findings.
 - determining the scope of the audit.
 - assigning the most competent staff to the particular engagement.
 - appraising each auditor's performance on at least an annual basis.
- Which one of the following alternatives is not in line with the rules of conduct or the standards as established by the Institute of Internal Auditors?
 - Mr. Jacobs has been assigned to audit the Finance Department, the department which he managed 26 months ago.
 - Your chief audit executive indicated to you that in order to ensure compliance with Standard 1312: External Assessment, the internal audit activity should conduct external assessment at least twice every five years.

TOPIC 1: INTERNATIONAL PROFESSIONAL PRACTICES FRAMEWORK (IPPF) REQUIREMENTS
PERTAINING TO THE PLANNING OF AN INTERNAL AUDIT

- (c) Mr. Maja, who is a certified internal auditor (CIA) and has more than five years of internal audit experience, has been assigned as an internal audit supervisor.
 - (d) Mr. Van Dyk has declined free movie tickets from the marketing department of the auditee.
3. In exercising due professional care, which of the following aspects should an internal auditor consider?
- i. the extent of work needed to achieve the engagement's objectives
 - ii. the relative complexity, materiality, or significance of matters to which the assurance procedures are applied
 - iii. the probability of significant errors, irregularities or noncompliance
- (a) i and ii
 - (b) ii and iii
 - (c) i, ii, and iii
 - (d) i and ii
-



FEEDBACK

- 1. (b)
Practice Advisory 2340–1, par 1
 - 2. (b)
Attribute Standard 1312
 - 3. (c)
Attribute Standard 1220.A1
-



Learning unit 3

Other internal auditing guidance impacting on the planning of an internal audit

Contents

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3.2	Supplemental guidance (Practice guides)	21

Strongly recommended IIA guidance consists of the Implementation Guidance (Practice Advisories) and Supplemental Guidance (Practice Guides) issued by the IIA Research Foundation.



READ

Read the section on **strongly recommended guidance** in *Reding et al*, chapter 2.

3.1 Implementation guidance (Practice advisories)

The Practice Advisories cover approach, methodology and considerations, but **not** detailed processes and procedures. They provide concise and timely guidance to assist internal auditors when applying the Code of Ethics and Standards and promoting good practices. These advisories include practices relating to international, national or industry-specific issues, specific types of engagements and legal or regulatory issues.



READ

The table that follows lists the Practice Advisories applicable to this module as well as the learning units in this study guide containing reference to any particular Practice Advisory listed.

Read the Practice Advisories indicated in your prescribed book: *Auditing legislation and standards*. Pay attention to the key concepts given in learning unit 2.1 above.

Attribute Standards			
Standard	Practice Advisories		Learning unit
1100	1100–1	Internal audit charter	LU 2.1
	1120–1	Individual objectivity	LU 1.1 & 1.2
	1130–1:	Impairment to independence or objectivity	LU 1.1 & 1.2
	1130.A1–1:	Assessing operations for which internal auditors were previously responsible	LU 1.1 & 1.2
1200	1210–1:	Proficiency	LU 1.1 & 1.2
	1210.A1–1:		LU 1.2

TOPIC 1: INTERNATIONAL PROFESSIONAL PRACTICES FRAMEWORK (IPPF) REQUIREMENTS
PERTAINING TO THE PLANNING OF AN INTERNAL AUDIT

Attribute Standards			
Standard	Practice Advisories		Learning unit
	1220-1:	Obtaining external service providers to support or complement the internal audit activity Due professional care	LU 1.1, 1.2 & 3.1.2
1300	1321-1:	Use of “conforms to the International Standards for the Professional Practice of Internal Auditing”.	LU 1.2
Performance Standards			
Standard	Practice Advisories		Learning unit
2000	2010-1 2010-2:	Linking the audit plan to risks and exposures Using the risk management process in internal audit planning	LU 3.1.2 LU 3.1.2
2100	Implementation Guide 2110	Governance	LU 3.1.1–3.1.3
2200	2200-1 2200-2: 2210-1: 2210.A1-1: 2230-1 2240-1:	Engagement planning Using a top-down risk-based approach to identify the controls to be assessed in an internal audit engagement Engagement objectives Risk assessment in engagement planning Engagement work programme Engagement resource allocation Engagement work program	LU 3.2 LU 3.1.2 LU 7.2 LU 3.1.2 LU 3.1.2 LU
2300	2320-1 2330-1: 2330.A1-1: 2330.A1-2: 2330.A2-1:	Analytical procedures Documenting information Control of engagement records Granting access to engagement records Retention of records	LU 5.3.2 LU 5.2 LU 5.2 LU 5.2 LU 5.2
2400	2400-1: 2410-1: 2420-1: 2240.A2-1: 2440-1: 2440-2:	Legal considerations in communicating results Communication criteria Quality of communications Communications outside the organisation Disseminating results Communicating sensitive information within and outside the chain of command	LU LU LU LU LU LU

3.2 Supplemental guidance (Practice guides)

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

All Practice Guides, Global Technology Audit Guides (GTAGs), and Guides to the Assessment of IT Risks (GAIT) automatically become part of the Recommended Supplemental Guidance layer.

The following General Practice Guides are applicable to this part of the module on tests of controls:

- *Integrated auditing*
- *Internal auditing and fraud*

Although reference will be made to important sections of these Practice Guides later on in the study guide, you are not at this stage required to study them in detail.



ACTIVITY 3.1

1. Attempt to answer the discussion questions based on the following scenario:

The audit committee has decided to change the structure of your internal audit activity. Currently, the internal audit activity consists of the chief audit executive (CAE) and two internal auditors, who are all situated at the head office. The CAE is involved in the daily performance of individual audit engagements.

The audit committee has decided to appoint three other internal auditors to relieve the CAE of his supervisory duties and enable him to spend most of his time on strategic issues. The CAE will now have more time to manage the internal audit activity effectively.

Required

Marks

- | | | |
|-----|--|-----|
| 1.1 | With reference to the Internal Auditing Standards and Practice Advisories, indicate the CAE's responsibility with regard to the planning of the internal audit activity. | (8) |
| 1.2 | Discuss the requirements of the Internal Auditing Standards and Practice Advisories with regard to resource management that should be kept in mind when appointing the three additional staff members. | (6) |



ACTIVITY 3.2

Do discussion question 7 in *Reding et al*, chapter 2.



TOPIC 1: INTERNATIONAL PROFESSIONAL PRACTICES FRAMEWORK (IPPF) REQUIREMENTS
PERTAINING TO THE PLANNING OF AN INTERNAL AUDIT

TOPIC SUMMARY

This topic discussed the requirements of the IPPF relevant to the planning of an internal audit engagement. The IIA Code of Ethics, the International Standards for the Professional Practice of Internal Auditing and the strongly recommended IPPF guidance were considered for their impact on the planning of internal audit engagements.

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

- demonstrate a solid knowledge and understanding of the provisions of the International Professional Practices Framework's (IPPF) which may impact on the way internal auditors plan internal audit engagements
- apply the guidance provided in the International Professional Practices Framework (IPPF) when planning internal audit engagements

PART B

Significant factors impacting on the planning of an internal audit

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TOPIC 2

Nature of the audit engagement

Contents

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LEARNING UNIT 5:	The engagement planning process	30

INTRODUCTION AND PURPOSE OF THE TOPIC

The purpose of this topic is to provide an overview of the different types of audit engagements internal auditors are involved in and to identify the activities necessary to plan an internal audit engagement.



LEARNING OUTCOMES

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

- distinguish between the different forms/types of internal audit engagements and recommend appropriate steps for the planning of each type of audit
 - apply and give advice on the skills and techniques required to plan and conduct an internal audit
-

Learning unit 4

Types of internal audit engagements

As internal auditing developed over the years, different applications of internal auditing came into being.

The Institute of Internal Auditors defines internal auditing as follows:

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

According to this definition, internal auditing is an assurance and consulting activity designed to add value and improve operations. The different internal audit engagements can therefore be divided into two categories: **Assurance engagements** and **Consulting engagements**. Reding *et al*, chapter 1, explains that assurance and consulting services differ in three respects:

- the primary purpose of the engagement
- who determines the nature and scope of the engagement
- the parties involved

The primary purpose of internal assurance services is to assess evidence relevant to the subject matter of interest to someone and provide conclusions regarding the subject matter. The internal audit activity determines the nature and scope of assurance engagements, which generally involve three parties: the auditee directly involved with the subject matter of interest, the internal auditor making the assessment and providing the conclusion, and the user relying on the internal auditor's assessment of evidence and conclusions.

The primary purpose of internal consulting services is to provide advice and other assistance, generally at the specific request of engagement clients. The client and the internal audit function mutually agree on the nature and scope of consulting engagements, which generally involve only two parties: the client seeking and receiving the advice, and the internal auditor offering and providing the advice.

Considering that internal auditors, according to the definition of internal auditing, may be assurance providers and/or consultants on risk management, control and governance processes in any type of organisation, the practice of internal auditing according to its definition provides for a wide variety of internal audit applications. All these different applications of internal auditing are aimed at improving organisational performance, but the distinction lies in the particular aspect of organisational performance that becomes the focus of the audit.



READ

The second-year Module AUI2601 provides a brief overview of the following types of audits:

- compliance audits
- financial audits
- performance audits
- environmental audits
- fraud audits

- quality audits
- programme results audits
- application or systems audits
- IT/IS audits

Refresh your memory of the different types of audits by reading section 7.1.3 of the AUI2601 study guide.



STUDY

Study the following paragraphs in *Reding et al*, chapter 12: *Introduction to the engagement process*:

Introductory paragraph

Types of internal audit engagements, including Exhibit 12–2

It is important to note that according to Standard 1000–1, the purpose, authority and responsibility of the internal audit activity must be formally defined in an internal auditing charter, consistent with the Code of Ethics, the Standards and the definition of internal auditing. The internal auditing charter therefore determines the scope of the internal audit activity and this is approved by the board or top management of the organisation.



STUDY

Study Attribute Standards 1000, 1000.A1 and 1000.C1 in *Auditing Legislation and Standards*.

Study Practice Advisory 1000–1 in *Auditing Legislation and Standards*.

(The internal audit charter is discussed in full in Module AUI3704.)



STUDY

Study the following sections in *Reding et al*, chapter 15:

Introductory paragraph

The difference between assurance and consulting services

Types of consulting services

Selecting consulting engagements to perform



ACTIVITY 4.1

Do **review** question 1 at the end of chapter 12 in *Reding et al*.

Do **discussion** question 5 at the end of chapter 12 in *Reding et al*.



FEEDBACK

The feedback provided below has been obtained from the Instructor's Guide to *Internal auditing: Assurance and consulting services, 2nd edition*.

Feedback on review questions

1. Internal auditors provide two types of services: assurance services and consulting services.

Three examples of assurance engagements:

- Assess the design adequacy and operating effectiveness of business process controls.
- Assess the design adequacy and operating effectiveness of information technology (IT) controls.
- Directly assess business process performance.

Three examples of consulting engagements:

- Provide advice to process owners about how they can streamline their processes to gain operational efficiencies.
- Facilitate process owners' assessments of the risk threatening their processes.
- Conduct in-house training about fundamental governance, risk management and control concepts.

Feedback on the discussion question

5. (a) The primary purpose of assurance services is to provide independent assessments, based on an objective examination of evidence, of an organisation's governance, risk management and control processes.

The primary purpose of consulting services is to provide advice, based on objective examination of evidence, that adds value and improves an organisation's governance, risk management and control processes.

- (b) Consulting engagements also differ from assurance engagements in terms of nature and scope. Whereas the nature and scope of an assurance engagement are determined by the internal audit function, the nature and scope of a consulting engagement are subject to agreement with the engagement client. Consulting engagements are accordingly much more discretionary in nature than assurance engagements.



ACTIVITY 4.2

Do review questions 1, 3, 4, 5 and 7 at the end of chapter 15 in *Reding et al.* (if using 2nd edition)

Do **review** questions 2, 4, 5, 7 and 8 at the end of chapter 15 in *Reding et al.* (if using 3rd edition)



ACTIVITY 4.3

Do discussion question 4 at the end of chapter 15 in *Reding et al.*



FEEDBACK

The feedback provided below has been obtained from the Instructor's Guide to *Internal auditing: Assurance and consulting services*, 2nd edition.

Feedback on the discussion question

4. In some instances, management or the audit committee may be somewhat averse to the concept that internal auditors should provide consulting services, primarily because they fear it would impair the internal auditors' objectivity.

Therefore, some internal audit functions may choose to omit specific references to consulting services in their charter. However, the authors believe it is important that the internal audit charter include provision for consulting engagements. Doing so outlines the need for the internal audit function to have access to all areas of the organisation when performing consulting engagements, as it does when performing assurance engagements. Not including consulting services in the charter may create confusion, should the internal audit function decide to provide any form of advice, and may increase the likelihood for disagreement regarding the internal audit function's position on consulting services.



Learning unit 5

The engagement planning process

Standard 2200–1 stipulates that internal auditors must develop and document a plan for each engagement, including the engagement’s objectives, scope, timing and resource allocations.



STUDY

Study the guidance provided in Practice Advisory 2200–1 pertaining to the planning of the audit engagement.

To be able to determine the activities involved in the planning of an internal audit engagement, it is necessary to study the engagement process. The purpose of this learning unit is to provide an overview of the engagement process for assurance and consulting activities and to identify and explain the steps related to the planning of an internal audit engagement.

Study exhibit 13–2: The assurance engagement process on page 13–3 of *Reding et al.* This illustration shows that the assurance engagement process is divided into three major stages/phases, namely: Planning, Performing and Communicating. The phases do not always follow in the order as indicated, but the steps are unique to each phase. For example, even though *communicating* is identified as a separate phase, audit planning may also include aspects that require communication. Some observations made by the auditor while gathering information for the planning of an engagement may, for instance, require immediate reporting and it may be necessary for the internal auditor to issue an interim report. In the planning stage, the internal auditor normally determines the work to be performed during the engagement and considers the reporting obligations that result from the engagement. While performing the engagement, the internal auditors may however, find conditions that may require an adaptation of the work programme. They may then have to go back to perform some of the steps belonging to the planning phase.

Study exhibit 15–3: The consulting engagement process on page 15–10 of *Reding et al.*



REFLECTION

Notice the difference between the planning activities for the assurance engagement and the planning activities for the consulting engagement.



FEEDBACK

The table below lists the planning activities of assurance and consulting engagements next to each other. Note the relationship between the two.

STEPS IN THE PLANNING PHASES FOR ASSURANCE AND CONSULTING ENGAGEMENTS

ASSURANCE ENGAGEMENTS

- Determine engagement objectives and scope.
- Understand the auditee, including auditee objectives and assertions.
- Identify and assess risks.
- Identify key control activities.
- Evaluate adequacy of control design.
- Create a test plan.
- Develop a work programme.
- Allocate resources to the engagement.

CONSULTING ENGAGEMENTS

- Determine engagement objectives and scope.
- Obtain final approval of objectives and scope from the engagement client.
- Understand the engagement environment and relevant business processes.
- Understand relevant risks, if appropriate.
- Understand relevant controls, if appropriate.
- Determine engagement approach.
- Evaluate control design, if appropriate.
- Allocate resources to the engagement.

From the comparison above, it can be observed that the objectives and scope of consulting engagements are determined based on the guidance provided by the engagement client and that the consulting engagement process is more flexible than that of the assurance engagement.

To be able to plan an internal auditing engagement, the internal auditor needs to have a thorough knowledge and understanding of the full engagement process. We will now go on to have a closer look at the different steps in each of the phases of the engagement process. Some steps and techniques applied in the planning phase will be discussed more fully in the remaining topics and learning units of this module. Performing the engagement is discussed in Modules AUI3702 and AUI3703 and discussions of the different aspects of communication are dealt with in each of the four third-level modules, as applicable.



STUDY

Study the following sections in *Reding et al*, chapter 12:

Overview of the assurance engagement process
The consulting engagement process



ACTIVITY 5.1

Do review questions 2 and 8 at the end of chapter 12 in *Reding et al*.



TOPIC SUMMARY

This topic discussed the different types of internal audits performed by internal auditors as well as the engagement planning process. You have learnt that internal audit engagements can be divided between consulting engagements and assurance engagements and that the consulting engagement process is a little more flexible than that of the assurance engagements.

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

- distinguish between the different forms/types of internal audit engagements and recommend appropriate steps for the planning of each type of audit?
- apply and give advice on the skills and techniques required to plan and conduct an internal audit?

TOPIC 3

Aspects of the business environment

Contents

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LEARNING UNIT 7:	Control risk self-assessment	44

INTRODUCTION AND PURPOSE OF THE TOPIC

In topic 3, we discussed the influence of internal audit methodology on the planning of internal audit engagements. In this topic, the impact of the business environment on the planning of internal audit engagements is considered.

According to the definition of internal auditing, internal auditors are involved in the evaluation of risk management, control and governance processes. These three issues, risk management, control and governance processes, will form a fundamental part of every assurance engagement and many consulting engagements. King III, principle 7.2–8 reads that *“internal audit, as a significant roleplayer in the governance process, should contribute to the effort to achieve strategic objectives and should provide effective challenge to all aspects of the governance, risk management and internal control environment”*.

You have already been introduced to the aspects of the business environment in your second year of study. We recommend that you refresh your knowledge of Module AUE2602: *Corporate governance in accountancy* before you commence your study of the learning units in this topic.

The purpose of this topic is to discuss the incorporation of risk management, control and governance processes in the planning of internal audit engagements. Since risk assessment forms an integral part of the planning process, this module discusses the concept of *risk management* in more detail. The concept of *governance* is discussed in more detail in Module AUI3702 and *Control* in Module AUI3704.



LEARNING OUTCOMES

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

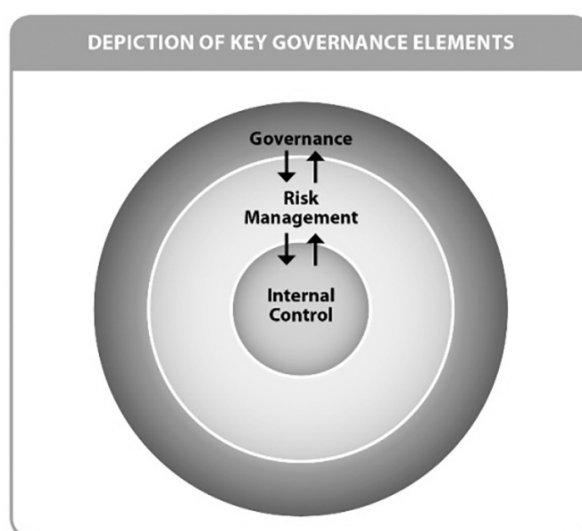
- analyse, criticise and make recommendations with regard to governance, risk management and control in different organisations.
 - describe suitable control self-assessment practices to assist with the process of risk identification and testing of controls.
-

Learning unit 6

Considering governance, risk management and control in planning an internal audit

Contents

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Source: Reding et al, chapter 3, exhibit 3–2

While studying the Standards relevant to planning in learning unit 2.2, you have learned that the chief audit executive must establish a risk-based plan (Standard 2010) and that this plan of engagements must be based on a documented risk assessment (Standard 2010.A1). This aspect of planning will be discussed in detail in Module AUI3704. However, for the purpose of planning the internal audit engagement, it is necessary for the internal auditor to consider the impact of governance, risk management and control processes on the nature, scope and extent of audit testing required in every audit engagement.

Standard 2100: Nature of Work states that *"the internal audit activity must evaluate and contribute to the improvement of governance, risk management and control processes using a systematic and disciplined approach"*.

King III recognises the internal audit activity's involvement in improving governance, risk management and control processes, and makes specific recommendations in this regard.

6.1 Governance

The picture at the beginning of this learning unit shows that governance surrounds all activities in an organisation. The governance structure may be established to comply with laws and regulations in the jurisdictions in which an organisation operates. These laws and regulations are typically promulgated to protect the public's interest. Additionally, the board and management of an organisation may establish governance structures to ensure that the needs of key stakeholders are met and that the organisation operates within the boundaries and values established by the board and senior management (*Reding et al: 3–1*).

In order to perform effective internal audits, an understanding of the organisation's business is essential. Part of this understanding is learning how the organisation is governed.



STUDY

Study the following section in chapter 3 of *Reding et al*:

Definition of governance

Revise topic 1 of AUE2602: *Corporate governance in accountancy* and work through the activities.

The internal auditor's responsibility to audit governance processes is described in Standard 2110: Governance.



REFLECTION

You have studied the standards applicable to the planning of an internal audit engagement in topic 2 of this module. Are you able to recall the responsibilities of the internal auditor according to Standard 2110: Governance?



FEEDBACK

Standard 2110 stipulates that the internal audit activity must assess and make appropriate recommendations for improving the governance process in its accomplishment of the following objectives:

- promoting appropriate ethics and values within the organisation
- ensuring effective organisational performance management and accountability
- communicating risk and control information to appropriate areas of the organisation
- coordinating the activities of and communicating information among the board, external and internal auditors, and management

The glossary to the Standards defines *governance* as follows:

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

Implementation Guide 2110 makes it clear, however, that the term *governance* has a range of definitions, depending on a variety of environmental, structural, and cultural circumstances, as well as legal frameworks. The definition of governance in the Standards glossary should be considered, along with governance frameworks and models published globally. Governance frameworks, models, and requirements vary according to organisation type and regulatory jurisdictions. How an organisation designs and practices the principles of effective governance also depends on such

factors as its size, complexity, life cycle maturity, and stakeholder structure, and the legal and cultural requirements to which the organisation is subject. The King Code and Report on Governance for South Africa, 2016 (King IV) serves as a guide and yardstick for good governance in South Africa. The governance of different organisations (companies, public sector organisations, municipalities, etc.) is prescribed further in the relevant acts (Companies Act, Public Finance Management Act, Municipal Finance Management Act, etc.).



STUDY

Study Implementation Guide 2110: Governance.

Governance does not stand on its own. It is closely linked with risk management and control. Practice Advisory 2110–2 explains that effective governance activities consider risk when setting strategy, but in turn, risk management relies on effective governance. Effective governance also relies on internal controls and communication to the board on the effectiveness of these controls. These relationships should be considered in the planning of an audit engagement.



ACTIVITY 6.1

Do review questions 1, 2 and 3 at the end of chapter 3 in *Reding et al.*



FEEDBACK

The feedback given below was obtained from *Internal auditing assurance and consulting services, instructor's guide*.

1. The arrows represent the flow of information throughout the governance structure. The board provides direction to senior management to guide them in carrying out the risk management activities.

Senior management, in turn, provides direction to lower levels of management, which are responsible for the internal control activities. However, lower-level managers are accountable to senior management with regard to the success of those internal control activities. And senior management is responsible for providing the board with assurances regarding the effectiveness of risk management activities. The arrows in the figure depict that flow of direction and accountability from one layer to the next.
2. The Organisation for Economic Co-operation and Development (OECD) defines corporate governance as follows: "Corporate governance involves a set of relationships between a company's management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of obtaining those objectives and monitoring performance are determined."
3. The first broad area of governance is strategic direction. The board is responsible for providing strategic direction and oversight relative to the establishment of key business objectives, consistent with the organisation's business model. Directors bring varied and diverse business experience to the board and, thus, are in a position to provide the strategic direction and oversight of that direction that will help the organisation to be successful. The board may also influence the organisation's risk-taking philosophy and establish broad boundaries of conduct based on the organisation's overall risk appetite and cultural values. Providing strategic direction, overseeing the objective-setting process, and monitoring progress

toward meeting the goals and objectives of the organisation are key reasons for the board's existence.

The second broad area of governance is governance oversight. This area involves the board understanding the needs of stakeholders, providing direction and authority to senior managers – who, in turn, empower risk owners to carry out that direction – reporting of risk management effectiveness up from risk owners to senior management to the board, and internal and external activities, most notably the internal and external auditors, providing assurances to senior management and the board as to the effectiveness of governance activities.

6.2 Risk management

The Committee of Sponsoring Organisations of the Treadway Commission (COSO) defines risk as “the possibility that an event will occur and adversely affect the achievement of an objective”.

The glossary to the Standards defines risk management as follows:

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

As depicted in the picture at the beginning of this learning unit, risk management, governance and control are interlinked. Risk management is influenced by governance and controls and at the same time risk management has an effect on governance and control. Internal auditing could play a critical role in an organisation's risk management processes, both in a consulting capacity or as an assurance provider.

Risk management affects internal audit planning in three ways:

1. Firstly, the internal auditor has to consider the organisation's risk management processes. This is commonly known as enterprise-wide risk management and includes the organisation's management of fraud risk.
2. Secondly, the risks of the internal audit activity need to be managed. If this risk is not managed, the internal audit activity could give false assurances and its reputation could suffer.
3. Thirdly, risk management has to be considered in the planning and execution of every internal audit engagement.

6.2.1 Enterprise-wide risk management

The Committee of Sponsoring Organisations of the Treadway Commission (COSO) defines enterprise risk management as:

A process effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its appetite, to provide reasonable assurance regarding the achievement of entity objectives.

Reding et al discuss different aspects of risk management that you need to acquaint yourself with.



STUDY

Study the following section in chapter 4 of Reding et al:

Overview of risk management



STUDY

Study the following section in *Auditing Legislation and Standards*:

Study Practice Advisory 2120–3: *Internal audit coverage of risks to achieving strategic objectives* (Issued in 2013)

Internal audit activities can play a valuable role in assessing the risk management efforts of an organisation or by playing a leading role in establishing enterprise-wide risk management in organisations. Enterprise-wide risk management also has an impact on the assurance provided by internal audit activities.



STUDY

Study the following sections in chapter 4 of Reding *et al*:

The role of the internal audit function in ERM

The impact of ERM on internal audit assurance

Study the following sections in *Auditing Legislation and Standards*:

Standard 2120: Risk Management

Practice Advisory 2120–1: Assessing the Adequacy of Risk Management Processes



ACTIVITY 6.2

Do review questions 1 and 2, at the end of chapter 4 in Reding *et al*.



FEEDBACK

The feedback provided below has been obtained from the *Instructor's guide to internal auditing: Assurance and consulting services, 2nd edition*.

Feedback on review questions

1. Risk is the possibility that an event will occur and adversely affect the achievement of an objective.
 2. The four fundamental points embedded in the Committee of Sponsoring Organizations of the Treadway Commission's (COSO's) definition of risk are:
 - Risk begins with strategy formulation and objective setting.
 - Risk does not represent a single point estimate.
 - Risks may relate to preventing bad things from happening or failing to ensure that good things will happen.
 - Risks are inherent in all aspects of life.
 - Risks are able to provide reasonable assurance to an organisation's management and board of directors
 - Risks are geared toward achievement of objectives in one or more separate, but overlapping, categories
-

6.2.2 Fraud risk management

One of the most significant risks faced by organisations is the risk of fraud. Fraud risk is also specifically mentioned in the Standards as a risk that the internal auditor should consider when planning and executing internal audit engagements.

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

Standard 1220.A1 states that “Internal auditors must exercise due professional care by considering the probability of significant errors, fraud or non-compliance”.

Standard 2060 states that “The chief audit executive must report periodically to senior management and the board on the internal audit activity’s purpose, authority, responsibility, and performance relative to its plan. Reporting must also include significant risk exposures and control issues, including fraud risks, governance issues, and other matters needed or requested by senior management and the board.”

In the light of this, it seems essential that internal auditors should have a good understanding of fraud and fraud risk, so that they will be able to plan audit work to identify fraud and be able to identify fraud when they stumble across it while executing an audit.

Fraud, as understood in the South African law, is defined as follows by criminal law jurist, CR Snyman (Snyman CR. 2008. *Criminal Law, 5th edition*. Lexis Nexis. South Africa. p 531):

“Fraud is the unlawful and intentional making of a misrepresentation which causes actual prejudice or which is potentially prejudicial to another.”

Learning unit 5.2 of the study guide for the second-year Module AUI2601: Internal Auditing II provides a good introduction to the internal auditor’s role and responsibilities with regard to fraud. It also discusses the South African definition of fraud.



STUDY

Revise learning unit 5.2 in the AUI2601 study guide, paying specific attention to section 5.2.1: *The nature and categories of fraud*.



STUDY

Study the following sections in chapter 8 of *Reding et al*:

Introductory paragraph

Overview of fraud in today’s business world

The fraud triangle

Key principles for managing fraud risk

Governance over the fraud risk management programme

Fraud risk assessment

Depending on the authority given to the internal audit activity by the board and audit committee, the internal audit activity has different responsibilities with regard to fraud. They may assist with initiatives to prevent and detect fraud and they may conduct fraud investigations as part of their consulting responsibilities. However, internal auditors have a responsibility to always consider the possibility of fraud while planning and conducting audit assignments. Standard 1220: Due Professional Care and the related Practice Advisory describe the internal auditor’s responsibility with regard to fraud risk.



STUDY

Study the following sections in *Auditing Legislation and Standards*:

Standard 1220: Due Professional Care

Practice Advisory 1220–1

Follow the links provided to study the following practice guides published by the Institute of Internal Auditors available at: <https://na.theiia.org/standards-guidance/recommended-guidance/practice-guides/Pages/Internal-Auditing-and-Fraud-Practice-Guide.aspx>



ACTIVITY 6.3

Do review questions, 5, 7 and 8 at the end of chapter 8 in *Reding et al.*

6.2.3 Risk management within the internal audit activity

Another aspect of risk management that the auditor should keep in mind when planning an internal audit engagement is the internal audit activity's responsibility to manage the risk of the internal audit activity. This aspect of risk management forms part of the managing of the internal audit activity and will be dealt with in more detail in AUI3704, but it is also important to consider the risks of engaging in an audit engagement when planning individual internal audit engagements.

According to Practice Advisory 2120–2, the risks associated with internal audit activities fall in three main categories, namely audit failure, false assurance and reputational risks. The Practice Advisory goes on to discuss the key attributes related to these risks and some steps an internal audit activity may consider to better manage them. It is important that you pay close attention to the issues dealt with in this Practice Advisory, as it has a direct impact on the planning of audit engagements.



STUDY

Study Practice Advisory 2120–2: Managing the Risk of the Internal Audit Activity.



REFLECTION

With reference to Practice Advisory 2120–2: Managing the Risk of the Internal Audit Activity, describe the value of the following key factors as part of managing the risk of audit failure.

- effective planning of internal auditing engagements
 - effective audit design
 - effective management review and escalation procedures
 - proper resource allocation
-



FEEDBACK

Effective planning

A thorough planning process that includes updating of relevant facts about the client and the performance of an effective risk assessment can significantly reduce the risks of audit failure. In addition, understanding the scope of the assignment and the internal audit procedures to be performed are important elements of the planning process, which will reduce the risks of audit failure. Building internal audit activity management checkpoints into the process and obtaining approval of any deviation from the agreed-upon plan are also key issues in ensuring that risks are properly managed.

Effective audit design

In most cases a fair amount of time is spent understanding and analysing the design of the system of internal controls to determine whether it provides adequate control prior to the start of testing for effectiveness. This provides a firm basis for internal audit comments addressing root causes, which may sometimes be the result of poor control design, rather than addressing symptoms. It will also reduce the chance of audit failure by identifying missing controls.

Effective management review and escalation procedures

Internal audit management's involvement in the internal audit process plays an important role in mitigating audit failure. This involvement might include work paper reviews, discussion of findings or a closing meeting. By including management of the internal audit activity in the internal audit process, potential issues may be identified and assessed earlier in the assignment. In addition, an internal audit activity may have guidance procedures outlining when and what types of issues to escalate to which level of internal auditing management.

Proper resource allocation

It is important to assign the right staff to each internal audit engagement. It is especially important when planning a higher-risk or a very technical engagement. Making sure that the appropriate competencies are available on the team can play a significant role in reducing the risk of audit failure. In addition to the right competencies, it is important to ensure that the team members have the appropriate level of experience, including strong project management skills for those leading an internal audit engagement.



STUDY

Study Practice Advisory 2230–1: Engagement Resource Allocation

6.2.4 Risk management in internal audit engagements

A final aspect of risk management that the internal auditor should be mindful of is managing the risks pertaining to the internal audit engagement.

It has been said before in this module that the plan of audit engagements to be performed by the audit activity during a year or longer (normally three years) is based on a comprehensive risk assessment conducted by the chief audit executive. Risks are those conditions that could adversely impact on the achievement of the organisation's objectives if they are not controlled. The comprehensive risk assessment referred to above is conducted on the organisation as a whole. The organisation establishes processes to execute its business plan and achieve its objectives. The audit engagements will individually attempt to provide assurance that each business process executes its business plan and achieves its objectives. Internal audit engagements may focus on a specific aspect of a business process or may focus on a business process in its entirety. The important thing to take cognisance of here is that risk exists in all processes. When planning an audit engagement, the focus of the auditing of risk management will be on how risk is managed to ensure that each business process achieves its objectives.



STUDY

Study Practice Advisory 2010–1: Linking the audit plan to risks and exposures

Study Practice Advisory 2010–2: Using the risk management process in internal audit planning

Study Practice Advisory 2210.A1–1: Risk Assessment in Engagement Planning

Study Practice Advisory 2200–2: Using a top-down, risk based approach to identify controls to be assessed in an internal audit engagement.

Study the following section in *Jackson & Stent*, chapter 7:

Understanding audit risk

Study the following sections in *Reding et al*, chapter 13:

Identifying key performance indicators

Evaluating process-level fraud risks

Identify and assess risks

6.3 Control

After having studied the second-year Module AUE2602, you should realise the importance of control for every organisation in managing its risks and achieving its objectives. Control processes ensure, among other things, that

- financial and operational information is reliable and possesses integrity
- operations are performed efficiently and achieve established objectives
- assets are safeguarded
- actions and decisions of the organisation are in compliance with laws, regulations and contracts

The role of the internal audit activity with regard to control is to assist the organisation in maintaining effective controls by evaluating their effectiveness and efficiency and by promoting continuous improvement.

According to Practice Advisory 2130–1: *Assessing the adequacy of control processes*, a key challenge for the internal audit activity is to evaluate the effectiveness of the organisation's control processes based on the aggregation of many individual assessments. Those assessments are largely gained from internal audit engagements, review of management's self-assessments and the work of other assurance providers. As the engagements progress, internal auditors communicate on a timely basis the findings to the appropriate levels of management so that prompt action can be taken to rectify or mitigate the consequences of control discrepancies or weaknesses discovered.

Internal audit engagements therefore contribute to the internal audit activity's overall evaluation of an organisation's control processes. Taking cognisance of this important fact is essential during the planning phase of each internal audit assignment.



STUDY

Refresh your basic knowledge of control by revising the following sections of your second-year study guides:

AUI2601: Learning unit 6.1, par 6.1.4 – *Control process*

AUE2602: Topic 2 – *Internal control*

Study Standard 2130: Control.

Study Practice Advisory 2130–1: Assessing the adequacy of control processes.



STUDY

Study the following sections in *Reding et al*, chapter 13:

Identify key controls

Evaluate the adequacy of control design

Create a test plan



ACTIVITY 6.4

Do review questions 11, 13 and 14 at the end of chapter 13 in *Reding et al*.

Module AUI3702 includes a detailed discussion of the concept of control and the internal auditor's responsibility in providing assurance with regard to an organisation's control processes.



ACTIVITY 6.5

Do discussion questions 5 and 6 at the end of chapter 13 in *Reding et al*.

Learning unit 7

Control risk self-assessment

Contents

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Learning unit 4.1 discusses the impact of an organisation's governance, risk management and control processes on the planning of an internal audit engagement. It is clear from the discussions in learning unit 4.1 that internal auditors have a responsibility to assess an organisation's risk management and control processes, not only as part of the overall planning of the internal audit activity, but also as part of the planning of individual internal audit engagements.

7.1 Nature of control risk self-assessment (CRSA)

Control risk self-assessment (CRSA) is described as a facilitated process whereby control owners provide a self-assessment of the design adequacy and operating effectiveness of controls for which they are responsible. Through control risk self-assessment, internal and operating staff collaborates to produce an assessment of an operation. This synergy helps internal auditing assist in management's oversight function by improving the quantity and quality of available information. The quantity is increased as internal auditing relies on operating employees to actively participate in CRSA, thus reducing time spent on information gathering and validation procedures performed during an audit. The quality is increased since participating employees have a more thorough understanding of the process than an auditor can develop over a relatively short period. CRSA, originally known as control self-assessment (CSA), was developed in the context of internal auditing, and today continues to be a process led by internal auditing. Nowadays, CRSA is a tool that is used by businesses to promote risk management in teams, projects, through processes and generally throughout the organisation. CRSA is both a management tool and an audit technique, depending on how it is applied.

7.2 CRSA purpose and benefits

The purpose of CRSA is to integrate business objectives, risks and control processes. It is used to set objectives, identifying the inherent risks that stop one from achieving the objectives and then working out which risks are most significant. Once the key risks have been identified, the team members go on to develop a strategy for managing the risks which will tend to focus on internal controls as a main component of the strategy. Allowing a team of people who have an interest in the area of focus to assess their risk management strategy results, provides a better understanding of the specific risks and controls in question, ensure that more buy-in is obtained in the process and result in action plans that are more realistic. CRSA supports the view that the responsibility for controls lies with those who operate them and those who manage the operations.

More distinctly, the following benefits of CRSA have been mentioned:

- It forces managers and their staff to think very carefully about their objectives and those of the organisation.
- It requires them systematically to identify, discuss and assess all the risks they face, to decide whether to accept these risks or whether to take action to reduce the level of risk by changing their approach or finding new ways of controlling risk.
- It places clear responsibility for control with line managers.
- The procedures used ensure that managers and their staff are fully involved in, as well as accountable for, controls and risk assessment.
- It provides an effective way of identifying and assessing key business risks, and ensures greater commitment of all.
- Attention is focused on the real objectives of the organisation.
- It gives managers and staff a much clearer awareness of what they and the organisation are trying to achieve.

7.3 Implementing CRSA

Internal auditors may use CRSA as an audit technique or may, as consultants, assist in establishing CRSA in organisations against the background of the internal auditor's expertise in this area. Practice Advisory 2120.1 advises that internal auditors should *"determine the effectiveness of management's self-assessment processes through observations, direct tests of control and monitoring procedures, testing the accuracy of information used in monitoring activities, and other appropriate techniques"*.

KH Spencer Pickett (2010, pp 528–531) describes the following approach to CRSA in his book, *The internal auditing handbook*, 3rd edition:

Steps to promote the implementation of CRSA in an organisation:

1. Ensure that the designated risk officer is fully acquainted with the theory of corporate governance, risk management and control.
2. Talk to other companies and people who have experience in developing CRSA in their organisations, or hire a consultant to perform a seminar on the topic.
3. Ensure that there is some expertise available in facilitation and related skills.
4. Introduce the CRSA concept – tell the board and audit committee about it and where it fits into the wider aspects of enterprise-wide risk management. If the organisation has an annual conference, then this would be a good opportunity to launch the initiative.
5. Get the board to endorse a suitable control framework on which to hinge the developing system of risk management. Risk scores may be measured against control models such as COSO or CoCo, using the categories that are suggested in each model. There needs to be a way of scoring or presenting risks, such as green, amber and red risks.
6. Get the board and audit committee to conduct their own CRSA workshop at the end of a formal meeting and use the experience and results to drive the initiative.
7. If internal audit is leading the move, then conduct a workshop within the internal audit workshop. Remember, the audit charter should refer to the services that are provided and if this should include CRSA facilitation, then amend the charter accordingly.
8. Secure a board-level sponsor for the programme and start planning. Work through ways of avoiding initiative overload by embedding CRSA into the way the business operates through the planning, communicating, decision making and performance management systems.
9. Undertake corporate road shows and introduce the concept of corporate governance reporting and the need for documented risk management. Make sure all key managers understand the CRSA process.

Performing CRSA workshops

Before the workshop

1. Get the right facilities to conduct the CRSA workshops. This will include a risk reporting system (based on risk registers), electronic voting software (if this is considered important – some simply use Post-it notes to good effect), suitable accommodation and most important of all – time made available for teams so that they are able to attend the events.
2. Make material available to everyone on the corporate intranet – with useful information, short online exercises and contracts for further information. It may be an idea to post a short guide to CRSA workshops onto the intranet, or have it sent out to key staff.
3. Talk to the manager of the workshop team in question and do some preparation in terms of who should attend and basic logistics. Decide on the focus, bearing in mind the different approaches and types of CRSA workshops using the process, projects, people or preparedness categories if appropriate.
4. The entire risk assessment system should be part of the enterprise-wide risk management drive. It should be forged around the board-level top 10 risks and become a published risk policy. Issue regular board briefings on the progress made.
5. It may be an idea to do a pilot workshop in areas that can show results quickly, without taking on very difficult parts of the business with entrenched problems that would be hard to turn around quickly.
6. Evaluate the results of the pilot with the board sponsor and adjust the approach accordingly.
7. Compile some pre-event material for each participant (e.g. the risk policy and a few challenging questions) and send it out in advance. Make sure there is a hotline to each participant for any questions. Otherwise contact each participant for a short talk over the phone and discuss the planned event. Most people are apprehensive about team events and feel that there is some hidden agenda that is being developed at senior level.
8. Check that the venue is suitable for the participants and that travel, accommodation and practical matters have been dealt with. The entire process must engender positivity all round.

At the workshop

1. Meet and greet the participants and get to know them before the official start of the workshop. Follow up on anything that has been discussed with them in the pre-workshop contact stage.
2. The facilitator and scribe should introduce themselves to the group and make it clear what they know about the team and what they do not know. (Facilitators need only be experts in getting the best out of people and ensuring that the workshop objectives are both achievable and achieved.)
3. Tell the group what is going to happen and how they should contribute.
4. Lay down the rules for the workshop, such as everyone should contribute, no dominance from the line manager, stepping outside the box through encouragement from others present, listening, respecting views, not violating the company policy on conduct and diversity, and so on.
5. It may be an idea to get a keynote speaker to introduce the workshop, say a senior manager or, ideally, the board sponsor.
6. Consider giving a brief presentation on corporate governance, risk management and control at the outset. Ideally, this would have already been done at staff awareness seminars on risk management and internal control. Introduce the concept of the risk register.
7. Get the participants to introduce themselves individually.
8. Ensure that there is a question-and-answer session at the start.
9. Start the event with clear objectives. An objective may be to get the participants to prepare mutually understood (and agreed) objectives, identify and assess risks and then develop risk management strategies determined in conjunction with the existing system of controls and

any refinements required. The results will then form part of the formal risk management reporting system to support the corporate published view on internal controls.

10. Use a prime business objective and, say, five or so supporting objectives. The group may split into subgroups to deal with these sub-objectives, although it is possible simply to ask the group what they prefer, as long as the workshop objectives are met.
11. Go through the standard stages of the CRSA process, including agreeing on objectives, setting the context by getting the group to discuss their performance management, planning and decision making and current change issues facing the area in question. Time may be spent on decision making and current change issues facing the area in question. Time may also be spent on discussing the stages in the decision making cycle in the work area and also on analysing external and internal stakeholders and discussing how their views are accounted for by the team.
12. Get the group to brainstorm operational risk at random. They can then classify the risks and vote on their relative importance – in terms of impact and likelihood. End with the top 10 or so risks to achieving business objectives or in not doing more by exploiting new opportunities.
13. A short presentation on internal control and what this means in practice may be necessary.
14. Start the problem-solving stage – this may be done at a separate event (or after a lunch break) so as to reinforce the move from problem identification (risk assessment) to problem solution (risk management).
15. Make the link between objectives, risk, cause and effect clear. (Problem solving is about identifying the causes of problems and not just the effects.)
16. Make sure the workshop is fully documented and agreed on with the resulting action plans giving details of risk owners, particulars of action required, dates and measures to ensure action taken has the required results. These action plans should be incorporated into the planning and decision-making mechanisms to promote integration of CRSA into the business culture.
17. Close the session with a “people check” – which entails going around the room and asking each person to sum up their experience and what they got from the event and asking whether they have any further points to add.

Ensuring continuation after the workshop

1. Risk assessment should be on the agenda at all group meetings, conferences and staff events – whenever there are problems or proposed changes, reference should be made to the current risk register and changes decided on.
2. Roll out the programme through and across the organisation and make sure reporting systems make sense and risks are managed in an accelerated manner. This allows the board to know about serious unmitigated risks, which may be monitored urgently or with frequent reports.
3. Make sure the risk register is a live document that is revisited whenever risks change materially and at least several times during the year.
4. Make each workshop a learning process that results not only in the action plan for risk/process owners, but also in a better use of the workshop format and the way it is facilitated.
5. The best CRSA processes make risk the key driver for business decisions and employee performance appraisal meetings should start with reference to the risk register most closely associated with the employee in question.

Be aware that the procedure described above is but one approach to CRSA. It may not always work and a process has to be adopted that suits the nature and operating style of the organisation.

Reasons why CRSA has failed have been identified from an internal audit perspective as

- a lack of a common body of knowledge and basic process blueprint for all to use
- a lack of good training and skills development

- failure to integrate control models into all audit work
- stubborn audit management that could not see beyond traditional audit approaches

It is essential for the success of a CRSA workshop to have a good facilitator. The CRSA process depends on a good control environment and open communications that engender trust and confidence. People will participate and add to a CRSA workshop if they

- are committed to the workshop objective
- have something of value to add
- believe that their opinion will be appreciated
- understand the CRSA process and where it fits into the business
- have confidence in the way the workshop is applied

Where each of the above aspirations is achieved, there is a good chance that the entire CRSA process will be successful.



ACTIVITY 7.1

XYZ Systems wants to implement a risk management system and the CFO approaches you for advice.

1. Motivate why you would advise XYZ Systems to conduct a control risk self-assessment exercise as part of the implementation of the risk management system.
 2. Provide the CFO with some tips on the steps that they can take to promote the implementation of CRSA within the organisation.
-



TOPIC SUMMARY

This topic considered the impact of governance, risk management and control on the planning of internal audit engagements. Since risk assessment forms an integral part of audit planning, more emphasis was placed on risk and its discussion covered the following aspects: enterprise-wide risk management, fraud risk management, risk management within the internal audit activity and risk management in internal audit engagements. The nature and role of control risk self-assessment was also discussed.

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

- analyse, criticise and make recommendations with regard to governance, risk management and control in different organisations
- describe suitable control self-assessment practices to assist with the process of risk identification and testing of controls

TOPIC 4

Information technology considerations

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INTRODUCTION AND PURPOSE OF THE TOPIC

Technological innovations have changed, and is still changing, the audit profession. Internal auditors are continuously adapting to technological innovations and assessing how such advances affect internal controls, financial reporting, and operations. In this topic you will learn how information technology should be considered and incorporated during the planning stage of an internal audit engagement.



LEARNING OUTCOMES

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

- identify and address or give advice regarding the relevant aspect of information technology to incorporate in the planning of an internal audit
 - apply and give advice on the computer related skills and techniques required to plan and conduct an internal audit
-

Learning unit 8

Incorporating information technology in the planning of an internal audit

Contents

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In chapter 7, *Reding et al (2009: p 7-3)* state that it is virtually impossible in today's business world for any internal audit function to provide value-adding services to their organisation unless the function is highly proficient in its knowledge of IT risks and controls and has the capability to effectively apply technology-based audit techniques.

Information technology (IT) can influence the planning of an internal audit in two significant ways:

Firstly, the nature and level of information technology incorporated into the audit client's systems and business processes will have an influence on the audit approach followed by the internal auditors.

Secondly, internal auditors will use information technology in conducting the audit, for purposes of planning, executing audit tasks, gathering of evidence and reporting.

8.1 The nature and level of information technology incorporated into the client's systems and business processes

IT has affected organisations. It has changed the manner in which organisations formulate strategies, conduct day-to-day operations, and make decisions. These changes have generated new risks and forced organisations to modify their governance, risk management and control processes. All internal auditors require a sound understanding of the fundamental IT concepts and especially the basic components of their organisation's information systems, IT risks, IT governance, risk management and control processes.



STUDY

Study the following sections in *Reding et al*, chapter 7:

- Key components of modern information systems*
- IT opportunities and risks*
- IT governance*
- IT risk management*
- IT controls*

Study the following sections in *Jackson & Stent*, chapter 8:

- Computer auditing*
- General controls*
- Application controls*

Study the following sections in *Jackson & Stent*, chapter 8:

Introduction

Networks

Electronic messaging systems

The Internet

Computer Bureaux

Viruses

The impact of IT on organisations has compelled internal auditors to upgrade their IT knowledge and skills and adjust how they perform their work.



STUDY

Study the following sections in *Reding et al*, chapter 7:

Implications of IT for internal auditors



ACTIVITY 8.1

Do **review** questions 1, 2 and 6 at the end of chapter 7 in *Reding et al*.



FEEDBACK

1. The six components of modern IT described in this chapter are computer hardware, networks, computer software, databases, information, and people.
2. Selling goods online is an opportunity enabled by e-commerce technology that many organisations have exploited (1). Other opportunities that IT advances have enabled include enterprise resource planning (ERP) systems and electronic data interchange (EDI).
6. (a) Objective setting – The IT governance process begins with the definition of IT objectives, which establish the direction of IT activities. Because IT enables the execution of business strategies and the achievement of business objectives, the strategic management of IT operations must be aligned with the overall strategic management of the organisation.
- (b) Risk assessment – Identified IT risk events must be assessed in terms of their inherent impact and likelihood. This assessment involves an analysis of the potential adverse consequences and causes of the risk events. The residual impact and likelihood of the identified IT risk events must also be assessed, taking into consideration existing risk management deficiencies.
- (c) Risk response – Appropriate risk responses must be formulated for identified IT risk events. Risk acceptance is an appropriate response for IT risk events with inherent impact and likelihood levels that do not exceed management's risk tolerance. Possible risk responses for IT risk events with inherent impact and likelihood levels that exceed management's risk tolerance include avoiding, reducing, or sharing the risk.
- (d) Information and communication – The purpose of an organisation's information systems is to identify, capture, and communicate high-quality information to decision makers on a timely basis. For example, information pertinent to identifying, assessing, and responding to IT risk events must be communicated throughout the organisation. An important aspect of IT risk management is ensuring that the organisation's technology-enabled information systems reliably produce high-quality information.



ACTIVITY 8.2

Do **discussion** question 5 at the end of chapter 7 in *Reding et al.*



FEEDBACK

Discussion questions

5. (a) COBIT® 4.1 is “a framework for control over IT that fits with and supports . . . COSO’s *Internal Control – Integrated Framework* . . .”
- (b) “. . . COBIT supports IT governance . . . by providing a framework to ensure that:
 - IT is aligned with the business.
 - IT enables the business and maximises benefits.
 - IT resources are used responsibly.
 - IT risks are managed appropriately.”
- (c) “The benefits of implementing COBIT as a governance framework over IT include:
 - Better alignment, based on a business focus.
 - A view, understandable to management, of what IT does.
 - Clear ownership and responsibilities, based on process orientation.
 - General acceptability with third parties and regulators.
 - Shared understanding amongst all stakeholders, based on a common language.
 - Fulfillment of the COSO requirements for the IT control environment.”
- (d) All internal auditors should, at a minimum, be aware of COBIT because it is an IT control framework that addresses IT risks, as well as IT governance, risk management, and control processes, all of which are integral to modern information systems.

8.2 Using information technology in internal audit engagements

Advances in both computer software and hardware have greatly increased the nature of the audit tasks which can be performed using a computer. Internal auditors can use a computer in all stages of the audit and for a variety of procedures. Computers can be used during the planning phase to perform initial risk analysis and to create engagement schedules and time budgets. New advanced software can, for example, be used to prepare internal control flow charts and to download client data for preliminary analytical testing.

Computer assisted audit tools/techniques (CAATs) are used to increase the efficiency and effectiveness of the audit process. There are three major types of CAATs: system based, transaction based and automated tools. System based CAATs are used in the planning phase of the audit to get an overview of the auditee’s operations. CAATs can be used to provide historical perspective on the audit client, provide summary information and examine trends. CAATs can also be used to evaluate risk areas. Audit related databases containing working papers from previous audits can reduce the time required to develop an audit programme.

Transaction based CAATs are used during the preliminary stage to determine risk and materiality issues, and during the fieldwork stages, to provide more detailed information about the audit client’s operations. Transaction-based CAATs can also be used for statistical sampling purposes.

Automated tools CAATs consist of several types of software packages designed to assist auditors in the performance and reporting of an audit by providing more attractive, and better understood documents.

The use of CAATs in an audit engagement will have an effect on many aspects that is considered during the planning of an audit engagement. Some of these include the time that needs to be allocated to certain audit tasks; the total duration of the audit; the way in which working papers and evidence will be kept; the skills that will be required of audit staff, the way stakeholders will be informed with regard to the progress of the audit; interim reporting etc. Should the auditors plan to use CAATs to gather evidence, previous consultation with the auditee is also essential. Auditors should therefore carefully consider the extent to which computers will be used in the performance of the audit engagement and the effect it will have on the engagement process.

Besides making auditing easier, CAATs can enhance the effectiveness and credibility of the internal audit activity.



STUDY

Study the following section in *Jackson & Stent*, chapter 8:

Computer assisted audit techniques (CAATs)

The use of mobile information and communication technology on audits

Study the following section in *Reding et al*, chapter 9:

Use of technology to support the internal audit process



ACTIVITY 8.3

1. List the system orientated CAATs and the data-orientated CAATs commonly used by auditors.
2. Discuss the factors which may influence an auditor's decision to use CAATs.



FEEDBACK

1.

System-orientated CAATs	Data-orientated CAATs
<ul style="list-style-type: none"> • test data • integrated test facility (ITF) • Parallel simulation • Embedded audit facility 	<ul style="list-style-type: none"> • Generalised/customised audit software • System utilities and report writers

Source: Jackson & Stent, p. 8/43–8/45

2. Factors that may influence an auditor's decision to use CAATs

- complexity of the client's system
- volume of transactions/output
- the form data is stored in
- availability of skills in the audit team
- potential loss of independence
- the attitude of the auditee
- compatibility of the auditor's hardware and software with the auditee's hardware and software
- utilities available in the auditee's systems which can assist
- cost associated with obtaining the relevant data

Source: Jackson & Stent, p. 8/46



TOPIC SUMMARY

This topic discussed the relevant aspects of information technology to consider when planning an internal audit engagement. Consideration was given firstly, to the nature and level of information technology incorporated into the audit client's systems and business processes that will have an influence on the audit approach followed by the internal auditors and secondly, how internal auditors may use information technology in conducting the audit, for purposes of planning, executing audit tasks, gathering of evidence and reporting.

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

- identify and address or give advice regarding the relevant aspect of information technology to incorporate in the planning of an internal audit
- apply and give advice on the computer related skills and techniques required to plan and conduct an internal audit

PART C

Planning the internal audit engagement

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TOPIC 5

Preliminary survey

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INTRODUCTION AND PURPOSE OF THE TOPIC

Internal auditors gather information to obtain sufficient knowledge of the activity under audit to enable them to plan the actual audit properly. This process is more critical for all first-time audits, but it is also an aspect that should not be neglected in repeat audits. During the preliminary survey of repeat audits, the internal auditor must identify any changes in the operations or business of the specific activity under audit that could impact on the business and the audit. The purpose of this topic is to guide you in learning how to conduct a preliminary survey of the area to be audited, according to the Standards and generally acceptable internal auditing practice.



LEARNING OUTCOMES

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

- identify, give advice on or criticise the methods and techniques applied to gather the data required for the planning of an internal audit, including statistical analysis and observation techniques
 - criticise and give advice regarding the adequacy, suitability, completeness and relevance of data gathered
 - conduct and analyse suitable analytical review procedures
 - apply or advise on the application of appropriate computerised audit tools and techniques
-

Learning unit 9

Planning skills and techniques

The benefits of a properly planned and successful preliminary survey will be felt almost immediately. An effective preliminary survey will focus on the available audit resources and result in a focused, effective and efficient audit that adds value to the specific activity.

On the other hand, if a preliminary survey is performed haphazardly, the internal auditor might uncover unpleasant surprises during the performance of the audit or even neglect to audit a high-risk and critical area, simply because it was not identified during the preliminary survey.

The following steps should be performed during a preliminary survey:

- An initial study should be conducted at the office of the internal audit activity to obtain as much information as possible on the operations of the auditee.
- Documents should be compiled to assist the internal auditor with the preliminary survey, and documents on the structure, regulations and operations of the auditee should be collected. Such documents may include the following:
 - Reminder lists should be compiled to guide the internal auditor during the execution of the preliminary survey.
 - A draft set of working papers can be assembled in preparation for the internal audit.
 - Questionnaires can be included, especially if the internal auditor plans to use control self-assessment methods during the performance of the engagement.
 - The internal auditor will arrange an initial meeting with the auditee and prepare to interview key personnel to gain a better understanding of the operations of the auditee.
- On completion of all the preparations, the internal auditor will commence gathering the required additional information on the structure, regulations and operations of the auditee.
- It is necessary to consider the organisational objectives, the objectives of the internal audit activity and the impact of any regulatory requirements and the Standards before the information collected during the preliminary survey can be used. All of this information is used to decide on the internal audit objectives for the specific engagement in such a way that it will add value to and improve the organisation's operations.

A preliminary survey starts with an initial study. The internal auditors can generally conduct this initial study from their offices. During the initial study for a repeat audit engagement, the internal auditor may review the prior year's audit working papers and audit findings which will enable him/her to take into consideration the results of any subsequent follow-up procedures. This review may highlight high-risk areas identified in the past, and the follow-up procedures will provide information on management's willingness and ability to act on reported concerns as well as their ability to implement improvements or corrective measures. For repeat engagements, the auditor may review the organisational policies and procedures, organisational diagrams and flow charts that are applicable to the specific engagement.

During the initial study for a first-time audit engagement, the internal auditor can gather a wealth of information on the activity under audit from the normal press, and in newspapers and magazines. A visit to the website of the auditee may also provide the internal auditor with valuable information, such as the auditee's vision, mission and policies and sometimes information on the procedures.

The study reference below will explain in greater detail what the internal auditor needs to do and consider during the preliminary survey.



STUDY

Study the following section in *Reding et al*, chapter 13:

Understand the auditee

Study the following section in *Reding et al*, chapter 15:

Planning the advisory consulting engagement: Understand the engagement environment and relevant business processes

The information required for different types of audits may differ to some extent. Background information required for the purposes of an **operational audit** might include the following:

(1) Information on the organisation and the audit field

The emphasis should be placed on those activities that fall within the scope of the operational audit. The following information would fall into this category:

- division of duties and responsibilities
- authority structures and management style
- nature, size and location of the various departments, sections and activities
- number of employees per department/section/activity
- nature and location of fixed assets and accounting records

(2) Information on specific legislation and regulations applicable to the audit field

The auditors should gain an understanding of the basic Acts and regulations applicable to the organisation and the audit field. Firstly, the auditor should familiarise himself or herself with the vision and goals of the organisation and the audit field in question, as well as the methods that should be used to achieve these goals. Secondly, the basic legislation that could apply to the organisation and the audit field should be studied, together with the applicable regulations and court decisions.

(3) Financial information

This information could include the following:

- cost of operations per period
- revenue from operations per period
- estimated and actual figures for the current, future and previous years
- cash-flow statements
- information from financial analysis

(4) Information on organisational policy and procedures

During this phase general information is gathered on the methods and procedures prescribed by management for the various activities; the precise procedures to be followed at the operating level are not investigated in depth.

(5) Management information and reports

The auditors should identify all the available management information and establish its nature, content and frequency. The auditors should also look out for management information that has been omitted and should be provided in future.

The auditors should identify which items management considers to be key indicators.

(6) Information on sensitive areas

The auditors should gather information on all the major problems within the department/section/ activity being audited. The areas where there is the biggest potential for improvement should be singled out. During an operational audit the auditors concentrate mainly on the material problem areas.

The following study reference describes the information that will be required during a preliminary survey for a **financial audit** and the techniques that will be used to obtain the information.



STUDY

Study the following section in *Jackson & Stent*, chapter 7:

Understanding the entity and its environment



ACTIVITY 9.1

Do the following questions at the end of *Reding et al*, chapter 13:

Review questions 5 and 6

Discussion question 6



Learning unit 10

Requirements for information/data gathering

The quality of internal auditors' conclusions and advice depends on their ability to gather and appropriately evaluate sufficient, appropriate audit evidence. Audit procedures are performed throughout the audit process to gather the evidence needed to achieve the prescribed engagement objectives. This process of the accumulation of evidence already begins with the initial survey discussed in 5.1 above.



STUDY

Study Standards 2300, 2310 and 2320

Study the following section in *Reding et al*, chapter 10:

Audit evidence

Study the following section under Audit evidence in *Jackson & Stent*, chapter 5:

Sufficient appropriate audit evidence

Study Practice Advisory 2130.A1–1: *Information reliability and integrity*

Preliminary surveys can be structured and conducted rapidly and efficiently if the internal auditors have a clear idea of what they wish to accomplish. Usually the essential information is classified under the four basic functions of general management, namely planning, organisation, directing and control. The use of general management terminology will enable the internal auditors to improve the effectiveness of communications with management, because in their operation of the organisation, management should use general management principles. In essence, using these principles will enable the internal auditor to speak the same language as management.

Planning

Planning is a complex and intertwining element of the management process and of all the activities of the organisation and makes the greatest contribution to the organisation's ultimate performance. For this reason, the internal auditor should evaluate planning activities with great care.

The internal auditor has to determine whether the management body is applying the following fundamental planning elements effectively and efficiently:

- Strategic planning should be done at regular intervals.
- An integrated planning policy should exist for the organisation as a whole in which each key aspect and activity of the organisation is included and in which the mutual relationship between and the influence of the activities are clearly indicated; this will ensure that the influence of any planning amendment on the rest of the activities in one or more respects can be easily ascertained.
- There should be strict adherence to planning decisions in endeavouring to achieve the organisation's overall objectives.
- Specific attention should be paid to the overall feasibility of all decisions.
- There should be regular and formal consideration of planning decisions by comparing these decisions and the actual state of affairs.

- Planning meetings should be attended by all key personnel, all submissions should be in writing and minutes should be kept of formal planning decisions.
- An effective system of control should be in place to ensure that all interested persons are informed of planning decisions.
- An effective reporting system should exist to ensure that planning decisions are amended in good time.
- Planning decisions should make express provision for addressing all business risks in particular.
- All important aspects of the organisation's planning must be linked to a system of sophisticated budgets.

Organising

Whereas planning entails indicating what the organisation wishes to do, organising entails indicating how this must be done. Careful synchronisation and close coordination are thus required when it comes to organising the planned activities.

As far as organisational policy is concerned, the internal auditor must investigate the following:

- The authority structure must be determined. Is the structure a traditional pyramidal one with numerous levels of authority, or is it a modern, flat structure with the minimum number of levels of authority and/or a system of participatory management? There must be evidence that this matter has been analysed in depth.
- Determine the policy of delegation and the associated accountability.
- Determine the policy with regard to centralisation, decentralisation and departmentalisation.
- Consider the efficiency and effectiveness in the establishment of the overall organisational plan.
- Determine whether there is an organisational plan and communication of the plan to all interested persons, for example by means of official organisational manuals.

Directing

The overall responsibility of management is to ensure that a personnel policy is in place which guarantees the existence of a cooperative employee corps which is skilled, competent, experienced, motivated and loyal.

The internal auditor will have to establish whether management applies a scientific personnel policy which ensures that all personnel perform optimally. General matters which are of importance in this regard are

- a detailed and orderly organisational chart
- formal personnel manuals which are supplied to all personnel
- a clear policy with regard to job descriptions
- appointment practices
- complete orientation of all personnel
- development practices
- incentive practices
- sound evaluation practices
- promotion practices
- leadership development
- strict, but personnel-friendly discipline

Control

The word "control" is used here in the context of total management control. The internal auditor must obtain adequate proof that management has fully identified every risk faced by the organisation, analysed the nature and scope of each such risk and arranged them in order of importance.

The application of the management principles described above will enable the internal auditor to ensure that all the internal audit recommendations are aligned with the overall organisational objectives to make improvements and add value. To obtain the best results, the internal auditor will have to follow a top-down approach, by first focusing on the overall management or executive management level before moving to the subordinate or lower management levels.

All the information gathered during the preliminary survey should be documented. Standard 2330: Documenting Information requires internal auditors to record the evidence they accumulate as support for engagement outcomes and Practice Advisory 2330–1 provides guidance regarding working papers and their preparation. Working papers are discussed in more detail in Module AUI3702.



STUDY

Study Standard 2330: *Documenting information*

Study Practice Advisory 2330–1: *Documenting Information*

Depending on the nature of the audit engagement, evidence gathered during the engagement may be more or less sensitive. Evidence gathered during a fraud investigation, for example, should be treated with the utmost care and should be locked away. Consideration should be given to the way evidence should be kept; who should be allowed access to the evidence obtained and for what period it should be retained. Audit team members should be adequately informed as to what is expected of them in this regard.



STUDY

Study the following Practice Advisories in Auditing Legislation and Standards:

2330.A1–1: *Control of engagement records*

2330.A1–2: *Granting access to engagement records*

2330.A2–1: *Retention of records*



ACTIVITY 10.1

Do the review questions 1 and 2 at the end of chapter 10 in Reding et al.



Learning unit 11

Techniques for information gathering and analysis

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The techniques applied by internal auditors to gather evidence is generally referred to as audit procedures. Audit procedures is described by *Reding et al* as specific tasks performed by the internal auditor to gather the evidence required to achieve the prescribed audit objectives.



STUDY

Study the following section in *Reding et al*, chapter 10:

Audit procedures

Some of the audit procedures most frequently used during the preliminary survey are *inquiry* and *analytical procedures*. Let's now look into these procedures in a little more detail.

11.1 Inquiry

Jackson & Stent describe "inquiry" as the seeking of both financial and non-financial information of knowledgeable persons within the entity or outside the entity.

The most frequently used techniques used to inquire are questioning and interviewing. Questioning can be done in face-to-face meetings with audit clients or by using questionnaires. Interviews may be conducted either face to face or telephonically. Good questioning and interviewing skills are important for the internal auditor to ensure that the effort and time put into it deliver the intended result.

11.1.1 Questioning

Internal auditors normally have a number of questions to ask the auditee. Asking pertinent questions may provide the auditor with significantly more comprehensive information than merely requesting copies of the auditee's organisational diagram or policy and procedure manual. Collecting documents will not give the internal auditor any assurance that the information documented by the auditee reflects the real situation, or that the policies and procedures that

were given to the internal auditor are up to date or reflect the actual approved methods of operation followed. Effectively questioning appropriate staff will, however, provide these insights.

A questionnaire provides a useful format and also creates an agenda for a meeting with a client. Appropriate answers to the questions in a questionnaire could provide the auditor with enough information to develop or update the following:

- the organisational diagram showing the different positions, the persons involved and the levels of authority
- the policies and procedures applicable to the engagement
- risk areas, such as untrained staff, inadequate supervision and frequent problems communicated by business partners

Questionnaires vary according to the unique setup and systems applied at each organisation. A questionnaire to obtain information on the purchasing system could include the following questions:

- decisions regarding what to purchase
- keeping a list of suppliers, and seeing that it is up to date
- checking and approval of purchasing specifications
- the purchasing process
- control over receipts
- evaluation of the performance of suppliers

Below is an example of a questionnaire that could be used to obtain more information on the procurement department in an organisation. This questionnaire merely serves as a guide and is not a complete list of questions.

PLANNING QUESTIONNAIRE – PROCUREMENT
<p>1. Status of the procurement department/section within an organisation</p> <ul style="list-style-type: none"> • Who does the head of procurement report to? • What form of control over procurement is exercised by <ul style="list-style-type: none"> – Executive directors outside the purchasing section? – Board of directors/board of management? – Acts/regulations? • Is there an organogram of the procurement department/section? Obtain a copy. • What are the responsibilities and duties of each employee in the procurement section? • Is there any division of procurement responsibilities between the various purchasers? If so, document how it is divided.
<p>2. Responsibilities of the procurement department/section</p> <ul style="list-style-type: none"> • Have the responsibilities of the procurement department been properly described in a document? Obtain a copy. • Do procurement staff and staff of other departments fully understand the duties of the procurement department/section? How is this ensured? • Is the purchasing department aware of procurement activities that are being performed by other departments within the organisation and that conflict with the functions of the procurement department/section? Document these functions. • Do any other sections/departments have contact with suppliers? • Is there close cooperation between the purchasing department and other operating departments as regards favourable purchasing opportunities, economic order quantities, changes in purchasing specifications? Document such activities.
<p>3. Authorisation of purchases</p> <ul style="list-style-type: none"> • What are the general requirements with regard to the authorisation of purchasing requisitions by the organisation. Obtain a copy of the policy.

<ul style="list-style-type: none"> • Are the authorisation procedures linked to the amount and the nature of the purchases? • Have the authorisation procedures been documented? • Are there any instructions with regard to special authorisations, such as in the case of capital expenditure or purchases that exceed the budget? Provide documents supporting such instructions. • What is the policy of the organisation if the eventual cost of a purchase exceeds the cost calculated with the original order? • What is the policy if any changes are made to the quantities and specifications on the original order documents?
4. Physical facilities <ul style="list-style-type: none"> • Are the layout and general facilities of the purchasing section conducive to effective functioning? Draw up a layout diagram.
5. Decentralised procurement <ul style="list-style-type: none"> • Is there any policy for purchases by decentralised operating units, such as petty cash purchases? Provide supporting documents.
6. Procurement procedures <ul style="list-style-type: none"> • Have procurement procedures been put in writing? If so, obtain a copy. • How are the following dealt with? Document the procedures. <ul style="list-style-type: none"> – Purchasing requisitions – Placement of orders – Documentation flow • Describe the procedures for inviting tenders • What specialised documents are used by the procurement department/section? • Is there any specific policy with regard to: <ul style="list-style-type: none"> – Local purchases where possible – Purchases from suppliers who are clients of the organisation – BEE requirements

Source: Adapted from the original source: Reider, HR. 1995. *Guide to operational auditing*.

11.1.2 Interviewing

During the planning stage of an audit, the interviews that take place are mainly with management. In the fieldwork phase, interviewing is extended to the staff who physically perform the activities under audit so that the auditor can determine how and why certain tasks are carried out. The first preliminary meeting will in all probability set the tone for the rest of the audit engagement. This underscores the importance of establishing proper communication.

The purpose of interviewing in the fieldwork phase is to compare theory and practice and gather facts, ideas and opinions. At the same time, the auditor must leave the client with a positive impression of himself or herself.

Scheduling the interview

The first step to a successful interview is to arrange the meeting. A suitable time and place should be arranged for the meeting beforehand, and surprise visits should be limited to those areas in which they are absolutely imperative. When scheduling an interview, the internal auditor should

- a. make advance arrangements
 - (1) Time and place; auditee's work area most desirable.
 - (2) Probable duration of meeting; limit to an hour or less.

- b. arrange favourable hours and days
 - (1) Avoid hours immediately before or after lunch.
 - (2) Avoid late Friday afternoon, day before or after a holiday.
 - (3) If possible, try for early morning, shortly after workday begins, or mid-afternoon.
- c. share the agenda and request materials
 - (1) Indicate the general subject of the meeting.
 - (2) Request materials: sample forms, statements, et cetera.
- d. keep interview generally one-on-one, with no supervisors or supervisees present

Preparing for the interview

A prerequisite for a successful interview is proper preparation. Auditors must work through all the documentation at their disposal before the commencement of an interview and should not ask questions during an interview if they should have known the answers from their study of the documentation. The following guidance should be kept in mind and may be used as a check list when preparing for an interview:

- a. Learn something about the organisation through
 - (1) policies and procedures
 - (2) operating manuals
 - (3) organisation charts and functional job descriptions
 - (4) legislation: laws, charters and ordinances
 - (5) reports: internal and external
 - (6) prior audit reports
 - (7) working papers
 - (8) technical journals
- b. Prepare an interview agenda.
 - (1) Write out basic questions.
 - (2) Review and rephrase questions.
 - (3) Organise and consolidate questions.
- c. How and what the internal auditor asks depends on whom he or she is talking to.
 - (1) Decision management: Aim at gathering information about policy and objectives:
 - (i) Do
 - ask about policy
 - ask about goals and objectives
 - encourage free exchange of ideas
 - sell yourself and the audit group
 - concentrate on the "big picture"
 - (ii) Don't
 - use technical terminology
 - get involved in great detail
 - inject yourself in the middle of a story; let the auditee talk
 - interrupt
 - criticise the operation
 - (2) Operating management: including departmental managers, supervisors and the like. Some of the areas to be covered with this group are work flow, present problems, relationship to other departments, and future improvements.
 - (i) Do
 - evaluate work flow
 - document functions of departmental personnel
 - sell yourself

- anticipate reluctance
 - plan ahead and be prepared to discuss operations
 - observe operations while you talk
- (ii) Don't
- use technical terminology
 - inject your ideas in the middle of a story; rather, direct the conversation
 - be reluctant to stimulate the auditee to action
 - ignore the day-to-day problems
 - gloss over interdepartmental relationships
- (3) Operating personnel: These include people responsible for a specific job.
- (i) Do
- have a list of questions
 - know the general work flow
 - be friendly and complimentary
 - sell yourself
 - concentrate on the areas of responsibility of the auditee
- (ii) Don't
- use technical terminology
 - use words that may allow the interviewee to draw the wrong inference
 - criticise the operations or personnel
 - try to overpower the auditee
 - allow the interview to deteriorate into a complaint session
- d. Remember, never go into the interview cold and unprepared; do your homework before the interview.

Conducting the interview:

To ensure an effective interview, it should be conducted in a structured way. The following should be kept in mind when conducting the interview:

1. *Opening the interview*
 - Be punctual; it helps your image.
 - Put the person at ease, but control the amount of small talk.
 - State clearly the purpose of the interview.
 - Assure the auditee that you will protect his or her anonymity if desired and if possible.
2. *Conducting the interview*
 - Be open, objective and reasonable.
 - Convey to the other person that the audit is a matter of joint concern.
 - Use your agenda to direct the interview and prevent undue wandering from the subject.
3. *Questioning the interviewee*
 - Ask questions that require more than a yes or a no.
 - Seek the other person's analysis of causes and effects; statements of things that are of concern to the auditee.
 - Do not ask loaded questions:
 - those that indicate that you have already assumed an answer
 - those that indicate what you would like to hear
4. *Taking notes*

Never record complete minutes, as it may adversely affect the other person and it is not conducive to good listening. The auditor will have to distinguish between material and immaterial items for recording.

5. Effective listening

- Ask the person to repeat or restate if you do not understand.
- Ask for concrete examples if language is general or vague.
- Summarise or rephrase in order to encourage elaboration.
- Ask the interviewee what he or she would do to correct or improve conditions.
- Allow periods of silence in which to think.
- Don't
 - debate or waste time in disagreeing over any point, no matter how important
 - be sarcastic
 - jump to conclusions
 - contradict a person in front of others
 - quote other people you have interviewed; the interviewee will not trust you to keep his or her responses confidential

6. Closing the interview

- Stick to the time schedule even if you have not finished your agenda; simply arrange for another meeting.
- If the other person wishes to extend the interview, then do so, but let this be his or her option, not yours.
- Before leaving, summarise the major facts obtained in the interview.
- Thank the interviewee for his or her time.
- Leave the door open for further questions or information.

7. Recording the interview

- Review, organise and record your notes as soon as possible after the interview, at least on the same day.
- Write out enough, so that conclusions are reasonably self-explanatory.
- Send a copy of your notes to the interviewee for his or her review and agreement, where appropriate.



STUDY

Study the exhibit on effective interviewing, exhibit 10–4, in *Reding et al*, chapter 10.



ACTIVITY 11.1

Read the interview between the auditor and the departmental manager provided below and document any critique you may have.

1. Auditor (walking into the departmental manager's office unannounced): "Good morning. We are conducting an operational audit in your department and I would like to ask you a few questions about the inventory system."
2. Departmental manager (looking up and looking at his watch): "Morning. I wasn't expecting you and I have a meeting in a few minutes' time, but let's see if I can help you quickly."
3. Auditor (sits next to the departmental manager and picks up a pencil from the desk): "What is the current status of the SSRP?"
4. Departmental manager: "The what?"
5. Auditor: "The SSRP – surplus stock removal programme?"
6. Departmental manager: "Oh, we last used that a long time ago."
7. Auditor: "I know, but can you explain to me how the programme works?"
8. Departmental manager (disconcerted): "I said the programme has not been used recently."
9. Auditor: "Could you give me a broad outline of the programme?"

10. Departmental manager (more upset): "Fine. The aim of the programme was to transfer surplus stock to another branch where there was a need for the items. But we did away with these transfers because there was not a good reporting system and we did not always ..." (he's interrupted)
11. Auditor: "Oh, so you only need to adapt the reporting system to get the SSRP to work. What inventory records are you keeping at the moment?"
12. Departmental manager: "We are using a real-time computerised inventory system."
13. Auditor: "I see. It seems to me that no matter what record-keeping system one uses, it is impossible to control inventory effectively. Most inventory systems I've had to do with were pretty inadequate. We'll see how good your system is."
14. Departmental manager (astonished – leans back in his chair): "Yes, well ..."
15. Auditor: "What does your delivery fleet consist of?"
16. Departmental manager (disconcerted again): "Two panel vans, one lorry and one station wagon."
17. Auditor (busy making notes): "Could you repeat that?"
18. Departmental manager (irritated): "Two panel vans, one lorry and one station wagon."
19. Auditor: "Is that all?"
20. Departmental manager (still irritated): "Yes, that's all!"
21. Auditor: "Who schedules the deliveries?"
22. Departmental manager: "The storeman schedules the deliveries and sends the drivers out."
23. Auditor: "Is the delivery schedule a formal written document?"
24. Departmental manager: "No, it isn't a formal document! Deliveries are scheduled from day to day, as required."
25. Auditor: "Do you keep any delivery records or records of the time spent on deliveries?"
26. Departmental manager: "No."
27. Auditor: "Have you ever calculated the cost of a delivery?"
28. Departmental manager: "No!"
29. Auditor: "That's funny! The storeman said you keep detailed records of all deliveries and what they cost. He thinks we could save a lot of money by discontinuing deliveries."
30. Departmental manager (amazed): "You're surely not suggesting ..."
31. Auditor: "Who put you in charge of inventory?"
32. Departmental manager (picking up a fat blue file): "Look, it's all here in the company's policy and procedures manual" (paging through the file). "Here it is!"
33. Auditor: "Good, I'll go and read it in my office. Do you have an organigram to give me?"
34. Departmental manager: "Yes, just a minute, I'll ask my assistant." (rings the assistant) "Anna, bring me a copy of our organigram quickly."
35. Anna (in the doorway): "I have an organogram for you, but it has not been updated for about three years."
36. Auditor: "Don't you have an up-to-date organigram? How can you work without one?"
37. Departmental manager (a bit embarrassed): "I'll let you have a copy once we've updated it."
38. Auditor (gathering up his notes and putting them in his pocket together with the manager's pen):
39. "I've made list of all the documents I need." (hands the list to the manager)
40. Departmental manager (looking through the list briefly): "I can't give you all this now, I'm already 20 minutes late for my meeting. I'll send these to you."

41. Auditor: "Oh, I didn't think it would be so much trouble." (takes the list back and copies it onto a piece of paper)
42. Departmental manager (getting up to go): "If you have any further questions, contact my secretary." (leaves the office while the auditor is still sitting there)

11.2 Analytical procedures

Standard 2320: Analysis and Evaluation states that internal auditors must base their conclusions and engagement results on appropriate analyses and evaluations.

Internal auditors can critically analyse the relationship between different combinations of operational and financial information at a given moment by using analytical procedures to compare information over different periods. Such analyses merely serve to indicate problem areas and do not in themselves form a basis for drawing conclusions.



STUDY

Study Practice Advisory 2320–1: Analytical Procedures

Analytical procedures are a vital aid in the planning stage of the internal audit process because they assist the internal auditor in identifying possible problem areas. Analytical procedures make a significant contribution to ensuring that an internal audit is conducted effectively. This aid can be used during all the stages of the internal audit process. Analytical procedures are viewed as the primary aid for gathering information. All the important analytical methods which can be employed are described and the calculations involved are explained in the sections below.

As you could see when studying the section on *Audit procedures* in *Reding et al*, a large variety of analytical methods can be employed. The choice of method to use will be determined by the nature of the information to be analysed and by the purpose of the analysis.

Analytical procedures may be divided into two broad categories:

- methods used to analyse events and results
- methods for calculating projections for planning purposes and with regard to efficiency measures and decision-making criteria

In both categories, ordinary calculations and mathematical models are used. You should be able to apply the latter by virtue of the knowledge which you acquired in the module dealing with quantitative methods.

The following examples will show how auditors utilise analytical procedures in practice.

Example 1: Analysis of the application of petty cash

Information:

One of the sections of an organisation which is supposed to channel all purchases through a central purchasing section has a petty cash advance of R3 000,00. Petty cash advances to this section for the year under review amounted to R162 000,00.

An analysis of 200 petty cash vouchers for the period under review showed the following:

- 150 of the petty cash vouchers were for purchases for amounts between R90,00 and R100,00.
- 130 of these 150 vouchers were for books.

- 30 of the remaining 50 petty cash vouchers were for repeat purchases from suppliers who were paid within 30 days according to the invoices. The average amount of these payments was R88,00.
- The remaining 20 petty cash vouchers were in respect of cash payments for an average amount of R28,46 per item.
- There was a total of 2 100 petty cash vouchers for the period under review.
- The policy of the organisation stipulates that all purchases over R100,00 should be channelled through the central purchasing section using a procurement requisition.

Calculations that the auditors may do, based on the above information:

- *Petty cash turnover: $R162\ 000/R3\ 000$ per time = 54 times*

Petty cash advances normally provide for the disbursement of small amounts for urgent purchases. In the light of this, it is reasonable to assume that a petty cash advance should be supplemented once a month. According to our calculations, the petty cash advance is supplemented once a week, which is too often.

- *Average amount of a petty cash voucher: $R162\ 000/2\ 100$ vouchers = R77,14*

As we said previously, the petty cash should only be used for purchases for small amounts. The average amount shown on the petty cash vouchers is, however, rather high.

- *Petty cash vouchers for amounts between R90,00 and R100,00: $150/200 = 75\%$*

– Extrapolation: $R162\ 000,00 \times 75\% = R121\ 500$'s worth of petty cash purchases are represented by vouchers for amounts of between R90,00 and R100,00.

– Book purchases for between R90,00 and R100,00 amount to $130/150 \times R121\ 500 = R40\ 500$ for purchases below R90,00.

– Invoices purchased: $30/50 \times R40\ 500 = R24\ 300$

– Remaining petty cash purchases: $R40\ 500 - R24\ 300 = R16\ 200$

– Turnover of remaining petty cash purchases: $R16\ 200/R3\ 000 = 5,4$ times

- *Estimate of an acceptable amount for petty cash advances:*

$420 (2\ 100 \times 20\%)$ vouchers @ R28,46 = R11 953,20 estimated annual advance supplements.
 $R11\ 953,20/12 = R996,10$. An acceptable petty cash advance would therefore be R1 000,00.

Conclusion:

The petty cash advance could be reduced to R1 000,00 and supplemented monthly if repeat purchases and book purchases were combined and channelled through the central purchasing section. In this way, the organisation would be able to invest less money in petty cash and enjoy the benefits of central purchasing.

Example 2: Analysis of inventory consumption

Information:

An organisation's inventory of unprocessed material amounted to R350 000 at the end of the past financial year and consisted of 6 000 items. An audit test of 113 items, based on acceptable statistical sampling methods, produced the following information:

1. Total value of items tested: R15 000,00
2. Total number of unusable inventory items: 20
3. Total value of unusable inventory items on the last day of the past financial year: R4 000,00
4. Total items used 1,5 times more during the past year than during the previous year: 45
5. Total value of these items: R6 200,00

Calculations on the basis of the above information:

1. Unusable inventory items:

Number of items $20/113 = 18\% \times 6\ 000$ items = 1 080 items

Rand value: $R4\ 000,00/R15\ 000,00 = 27\% \times R350\ 000 = R94\ 500$

That is: 18% of 6 000 inventory items, calculated as 1 080 items, could not be used during the past financial year. 27% of the inventory value, calculated as R94 500,00 was unusable.

This information can be used to determine why the organisation allowed unusable inventory to accumulate until it amounted to such a large percentage of total inventory. Methods of getting rid of this inventory should be considered.

2. Greater usage of inventory during the past financial year:

Number of items: $45/113 = 40\% \times 6\,000 \text{ items} = 2\,400 \text{ items}$

Rand value: $R6\,200,00/R15\,000,00 = 41\% \times R350\,000,00 = R143\,500,00$

Conclusion:

About 40% of the inventory items, calculated as 2 400 items with a value of R143 500,00, showed a usage of more than 1,5 times that of the previous financial year. These facts, linked to the increase in unusable inventory, may be an indication that there was a change in the line of products manufactured without a corresponding adjustment in inventory purchases. Further analyses may be carried out to determine whether re-order levels and order quantities were revised to adapt to the recent increase in consumption. Analyses may also be done in order to determine whether the organisation had run out of stock during the previous financial year and, if so, what these situations cost the organisation.



ACTIVITY 11.2

On the basis of the data supplied below, calculate what it costs the particular organisation to generate and order.

Number of standard order forms:	18 100
Total salaries – Purchasing department: (directly related to the generation of order forms)	R384 587,00
Other direct costs:	R243 264,00
Indirect costs: (allocated to the generation of order forms on the basis of the relationship between salary costs directly related to the generation of order forms to total salary costs for the purchasing department)	R95 059,00
Fringe benefits: (percentage of salaries)	28%
Other expenditure allocated to purchases: (other expenditure within the organisation that can be directly related to the generation of order forms)	R101 000,00



FEEDBACK

Salary costs – Purchasing department	R384 587,00
Other direct costs	R243 264,00
Indirect costs	R95 059,00
Fringe benefits (28% of R384 587,00)	R107 684,00
Other expenses allocated to the generation of order forms	R101 000,00
Total cost of generating order forms	R931 594,00

The cost of generating one order form therefore amounts to:

$R931\,594,00/18100 = R51,00 \text{ per order form}$

The following important financial ratios usually provide valuable information during the planning of the audit:

11.2.1 Short-term liquidity ratios

Inventory turnover rate

This ratio provides an indication of the number of times trading inventory is sold during a period of 12 months. If there is a significant deviation from the normal or expected inventory turnover, this may be attributed to various possible causes, such as obsolescence of inventory, overinvestment in inventory, errors in determining the volumes and/or values of inventory or errors in determining the purchase figure for the year. The formula used for calculating this ratio is as follows:

Cost of sales/average inventory [(opening inventory + closing inventory)/2] = number of times that inventory is sold during a year

Average outstanding term of debtors

This formula provides information on the credit policy and credit control of the organisation, with any significant deviations being indicative of possible noncompliance with this policy, inadequate control over debtor collections and/or errors in credit sales and/or debtor records. The formula for calculating the average outstanding term of debtors is as follows:

Average outstanding debtors/credit sales x 365/1

Average outstanding term of trade creditors

This formula provides information on creditor payment policy or capacity. Any significant difference may indicate a departure from this policy, deterioration in the capacity to make regular payments, or errors in the credit purchases and/or creditor records. The formula for calculating this term is as follows:

Average outstanding trade creditors/credit purchases x 365/1

Current ratio

This ratio provides information on the organisation's short-term financing structure, that is, its capacity to pay short-term liabilities from short-term assets. A significant deviation from the objective may be indicative of a departure from the policy which has been laid down, an improvement or deterioration in the cash flow, or errors in one or more records pertaining to short-term assets or liabilities. The formula for calculating this ratio is as follows:

Current assets/current liabilities

Acid test ratio

This ratio provides information on the number of times that current liabilities are covered by realised assets. It therefore indicates how quickly the enterprise can redeem its short-term obligations. This ratio is an important indicator of an enterprise's liquidity. The formula for calculating this ratio is as follows:

Cash + short-term investments + debtors (or current assets excluding inventory)/current liabilities

Cash ratio

This ratio indicates whether the enterprise has sufficient cash funds to redeem its short-term debts immediately. It also provides the strongest indication of the enterprise's liquidity. The formula for calculating this ratio is as follows:

$$\text{Cash} + \text{short-term investments} / \text{current liabilities}$$

11.2.2 Performance ratios

Gross profit ratio

This ratio is an important indicator of the organisation's results. A significant deviation from the objective may point to a departure from the policy laid down regarding fixing of selling prices (the adding of profit to the cost price) and/or to errors in the records regarding each one of the components which play a role in the formula.

This result is expressed as a percentage of turnover or a percentage of the cost price of sales. The formulae for calculating these ratios are as follows:

$$\text{Gross profit} / \text{turnover} \times 100/1 = \text{Gross profit on turnover \%}$$

$$\text{Gross profit} / \text{cost price of sales} \times 100/1 = \text{Gross profit on cost price \%}$$

Net profit ratio

This ratio indicates the final result in respect of the year's activities. A significant deviation from the objective may be caused by a departure from the policy determining profit, by the results which are better or poorer than those budgeted for and/or by errors in one or more of all the components which determine the net profit, that is, all operating income and expenditure. The formula for calculating this ratio is as follows:

$$\text{Net profit} / \text{turnover} \times 100/1 = \text{net profit on turnover}$$

Profitability ratio

This ratio indicates how profitably the organisation's current assets are being employed. The reasonableness of the ratio is determined by taking into account the reasonable risk associated with the nature of the particular organisation's activities and/or by comparing the results with those of similar organisations. The formula for calculating this ratio is as follows:

$$\text{Net profit} / \text{tangible operational assets}$$

Efficiency ratio

This ratio indicates how efficiently the current assets are being employed in order to generate business. The reasonableness of this ratio can be assessed by taking into account the nature of the business and of the current assets, and by comparing the result with those of similar enterprises. The formula for calculating this ratio is as follows:

$$\text{Turnover} / \text{tangible operational assets}$$



ACTIVITY 11.3

Use appropriate financial ratios to do the following activity:

A medium-sized manufacturer of farm implements, Innovative Agri, wishes to purchase large quantities of custom-built steel castings from your company. The sales manager of your company has asked you to help him evaluate the financial soundness of

Innovative Agri. You determine that for the most recent fiscal year, Innovative Agri had a current ratio of 2,8, compared with 1,9 in the previous year, and a net operating loss which was double that reported in the previous year.

1. Explain why the increase in Innovative Agri's current ratio would not have been expected.
2. Give two possible causes that may account for the increase in the current ratio.
3. Explain why the acid test ratio may be better than the current ratio as a measure of Innovative Agri's ability to pay for purchases as they become due.
4. Identify four different turnover ratios and their formulae which could be used to assist with the evaluation of working capital.
5. Identify two ratios and their formulae that may give an indication of Innovative Agri's ability to pay its long-term financial obligations as they become due.



FEEDBACK

1. **Why the increase in Innovative Agri's current ratio would not have been expected**

When a business entity incurs losses, it does not generate cash or similar assets, but instead uses more cash or credit sources to finance these losses. The current ratio reflects the ratio between the current assets and the current liabilities. In a normal loss situation, the current assets should decline and the current liabilities should increase, which leads to a weaker current ratio.

2. Possible reasons for the increase in the current ratio

- Innovative Agri must have obtained cash from somewhere by virtue of a transaction from which one leg influenced current assets and the other leg influenced another item on the balance sheet. The cash was paid into the bank account and/or used to pay creditors.

Possible cash sources:

selling fixed assets or investments

obtaining long-term loans

issuing share capital

- It is possible that a large portion of the expenses that caused the loss do not represent a cash outflow, for example depreciation.

3. **Why the acid test ratio is better than the current ratio as a measure of Innovative Agri's ability to pay for purchases as they become due**

The acid test ratio differs from the current ratio in that it includes only cash and near-cash assets, such as marketable securities and accounts receivable, whereas the current ratio also includes other current assets such as inventories and prepaid expenses. Hence, the acid test may indicate more clearly Innovative Agri's short-term ability to pay its debts as they become due.

4. Different turnover ratios and their formulae

Ratio	Formula
Inventory turnover:	Average inventory/cost of goods sold or net sales
Accounts receivable turnover:	Average accounts receivable balance/net credit sales
Accounts payable turnover:	Average accounts payable balance/net purchases
Current asset turnover:	Current assets/net sales

5. **Ratios and their formulas indicating Innovative Agri's ability to pay its long-term financial obligations as they become due**

Ratio	Formula
Debt equity ratio:	Total liabilities/shareholder's interest
Liability settlement ratio:	Total liabilities less cash/annual cash flow from profits

11.3 Computerised techniques for data gathering

Computer assisted audit tools (CAATs) are effectively used to gather data in the planning phase of an audit. CAATs are especially helpful where large volumes of data are kept in multiple locations.

Auditors make use of information retrieval and analysis programs and procedures that organise, combine, extract and analyse information. This includes generalised audit software as well as application and industry-related software. Customised audit software and information retrieval software as well as standard utilities and on-line inquiry may also be utilised for information retrieval and analysis. Auditors do not require skills in programming, and knowledge of conventional programming languages to conduct these tests. Microcomputer-based software is readily available and provides even the auditor without technical expertise with very useful computer power.

Generalised audit software (GAS) is software designed specifically for auditors in order to provide a user-friendly audit tool to carry out a variety of standard tasks required by the auditor such as examining records, testing calculations, and making computations. (Cascarino RE.2007. Auditor's guide to information systems auditing. p 129.)

GAS is specifically suitable for selecting and analysing vast quantities of data. Although it cannot solve all the auditor's problems, it can be used to reduce audit time and to free the auditor to spend more time on the interpreting of results, instead of gathering data.



ACTIVITY 11.4

ACL and IDEA are two of the best known GAS packages. The CD that was issued with your prescribed book, *Reding et al*, contains demonstration versions for both of these programs. Do some exploring on your own to discover the functions offered by these software programs.



STUDY

Refer to your study of topic 4 and pay specific attention to the techniques aimed at the gathering of data as they are described there.



TOPIC SUMMARY

This topic discussed various skills and techniques as well as the requirements for planning and data gathering during the preliminary survey.

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

- identify, give advice on or criticise the methods and techniques applied to gather the data required for the planning of an internal audit, including statistical analysis and observation techniques?
- criticise and give advice regarding the adequacy, suitability, completeness and relevance of data gathered?
- conduct and analyse suitable analytical review procedures?
- apply or advise on the application of appropriate computerised audit tools and techniques?

TOPIC 6

Documenting business cycles and processes

Contents

LEARNING UNIT 12: Documenting business cycles and processes

80

INTRODUCTION AND PURPOSE OF THE TOPIC

Auditors may choose to document business cycles either by using flow charts or by describing the cycles. Flowcharting can be a highly effective and visual means of documenting the flows of the different business processes. Existing flow charts can be studied during the initial planning stages and used as a basis for discussing the business processes during the first meetings with the auditee. Auditors should know the basic techniques of drawing flow charts and should be able to interpret them. In this topic, you will learn how to create, apply and analyse process maps and flow charts.



LEARNING OUTCOMES

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

- create, apply and analyse process maps and flow charts
 - compose narrative systems descriptions
-

Learning unit 12

Documenting business cycles and processes

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12.1 Flow charts

Flow charts are used to document activities and procedures or physical layout.

System flow charts are graphic representations of the sequence of various activities in a process. They provide an indication of what work is carried out, how it is carried out and who does the work; systems flow charts help auditors to understand the system.

System flow charts are especially useful for showing what documentation is used at different stages of the process and where it is used. Compiling a systems flow chart requires auditors to document their understanding of a particular system. This procedure helps to stimulate the auditor's interest and mental processes so that he or she is eventually better able to identify weaknesses in the system. Knowledge of the compiling and interpretation of flow charts is equally important in operational auditing. The following information can be obtained from studying system flow charts:

- the way in which activities are physically carried out
- the need for or usefulness of the various steps followed in a process
- the effectiveness of controls used in the process
- inefficiencies in a system, such as
 - unnecessary handling
 - information on documents and records that is not used
 - inadequate planning or delegation/inadequate instructions/shortages or surpluses of equipment
 - inadequate instructions
 - shortages or surpluses of equipment/underutilised data-processing facilities/poorly planned reports
 - injudicious scheduling

Layout flow charts are schematic representations of the physical layout of working areas, with an indication of the most important functions performed there.

Layout flow charts are used to show the existing layout of working areas and the movement of people, documents and goods within those areas.

A study of layout flow charts can reveal the following to auditors:

- inefficiencies, such as
 - inadequate or surplus office equipment
 - inefficient office layouts

- potential personnel obstacles to the achievement of economic, efficient and effective activities, such as
 - individuals who perform supervisory functions but do not add any value to the process themselves
 - individuals who act as intermediaries, receiving work from one source and immediately passing it to someone else, but who do not add value to the process
- pyramidal structures with an upward control function, which lead to duplication of functions and excessive control



STUDY

Study the following sections in *Reding et al*, chapter 13:

Documenting the process flow

High-level flow charts

Detailed flow charts

Study the following examples of flow charts in *Jackson & Stent*:

Chapter 10: *Flow charts for a manual revenue and receipts cycle*

Chapter 11: *Flow charts for a manual acquisitions and payments cycle*

Chapter 13: *Flow charts for a manual wage system*

12.2 Narrative descriptions

Should auditors decide to do narrative descriptions of business processes, there are also some key points to consider.



STUDY

Study the following sections in *Reding et al*, chapter 13:

Narrative memoranda

Pay careful attention to the following examples of narrative descriptions in *Jackson & Stent*:

Chapter 10:

A narrative description of a computerised revenue and receipts cycle

Narrative description of the revenue and receipts cycle at Proride (Pty) Limited

Chapter 11:

A narrative description of a computerised acquisitions and payments cycle

Chapter 13:

A narrative description of a manual (wage) payroll system by function



ACTIVITY 12.1

Do the review question 8 at the end of chapter 13 in *Reding et al*.

8. The three common ways are high-level flow charts, detailed flow charts, and narrative memoranda.
-



TOPIC SUMMARY

This topic discussed the documentation of business systems either by making use of flow charts or by using narrative descriptions.

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

- create, apply and analyse process maps and flow charts
- compose a narrative systems description

TOPIC 7

Determining the scope and objectives of the engagement

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INTRODUCTION AND PURPOSE OF THE TOPIC

When planning an internal audit engagement, it is essential to obtain clarity on what the engagement is intended to achieve and what the engagement will and will not cover. The purpose of this topic is to learn how to determine these two important aspects, known as the *objectives* and *scope* of an audit engagement.



LEARNING OUTCOMES

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

- determine the objectives of an internal audit engagement according to the IPPF
 - determine the scope of an internal audit engagement according to the IPPF
-

Learning unit 13

Determining the scope of the engagement

The background information gathered in the preliminary survey should now be constructively used. The information collected provides the background against which the operational auditing staff will perform the audit. Such information also pinpoints the specific areas that should be investigated in the course of fieldwork. The general purpose is to concentrate on any areas that require urgent attention or areas where there is a great potential for improvement.

The scope of an audit engagement refers specifically to the nature, timing and extent of audit procedures to be performed during the engagement. Nature refers to the type of evidence (evidence of compliance, performance, environmental safety, etc). Timing refers to when the evidence will be gathered (evidence relating to the period between 1 January 20xx and 30 June 20xx). Extent refers to how much of what type of evidence to be gathered (the detail covered by the audit).

In view of restrictions in respect of the time and funds budgeted, internal auditors need to set specific limits for the scope of an audit. Standard 2220 states that the established scope must be sufficient to satisfy the objectives of the engagement.



STUDY

Study Standards 2220.A1, A2, C1 and C2 in *Auditing Legislation and Standards*.

Study the following sections in *Reding et al*, chapter 13:

Scope of the engagement

Expected outcomes and deliverables

Study the following sections in *Reding et al*, chapter 15:

Planning the advisory consulting engagement: Obtain final approval of objectives and scope from consulting engagement customer



Learning unit 14

Determining the engagement objectives

During the planning stage, the auditors should specify what they intend to achieve by performing an operational audit on the identified area and determine the boundaries of the investigation. These audit objectives should be agreed by top management and the management of the department or division in question.

The audit objectives for the auditing of the obtaining of tenders/quotations activity of the purchasing process could, for example, be the following:

1. Establish what procedures could be followed in procuring quotations and tenders to optimise the effectiveness of the purchasing function.
2. Develop procedures for the procurement of quotations and tenders that would contribute to the most efficient and economic functioning of the purchasing function.
3. Identify opportunities for improving the existing procedures for procuring quotations and tenders.
4. Revise and analyse the existing data processing procedures for procuring quotations and tenders in the purchasing function with a view to possible improvement.



STUDY

Study Practice Advisory 2200–1: Engagement Planning and Practice Advisory 2210–1: Engagement Objectives.

It is important to keep in mind that internal auditors must follow a risk based approach. This means that internal auditors should focus on those areas posing the greatest risk to the organisation. The general idea behind this is that internal auditors want to concentrate on and apply their resources to those areas that require urgent attention or areas where there is great potential for improvement.

There are a number of reasons why audits should be performed.



READ

Read the following section in *Reding et al*, chapter 13:

Reasons for conducting an engagement



STUDY

Study the following section in *Reding et al*, chapter 13:

Establishing engagement objectives

Study the following section in *Reding et al*, chapter 15:

Planning the advisory consulting engagement: Determining engagement objectives and scope



ACTIVITY 14.1

Why is it necessary to establish engagement objectives at the beginning of each engagement?



FEEDBACK

Without the establishment of formal engagement objectives, the internal audit team may not be aligned with the reasons for the engagement and, consequently, may perform inadequate or unnecessary tasks.



TOPIC SUMMARY

This topic discussed the important issues of determining the scope and objectives of the audit engagement. Without proper consideration of these issues in the planning phase of an audit, audit engagements will not be successful, audit time will be wasted and value added will be limited.

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

- determine the objectives of an internal audit engagement according to the IPPF
- determine the scope of an internal audit engagement according to the IPPF

PART D

Planning for effective communication and reporting during the internal audit engagement

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TOPIC 8

Communication techniques

Contents

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INTRODUCTION AND PURPOSE OF THE TOPIC

The key to successful, value adding audit engagements is communication. An audit without communication is meaningless – just as meaningless as preparing a meal if nobody is going to be home for dinner! Different audit engagements require different methods of communication and call for a variation in communication techniques, levels of communication and frequency of communication. If the internal auditors want to communicate effectively, they have to plan it.

The purpose of this topic is to teach you how to communicate effectively during the planning phase of an audit engagement, to obtain approval of the audit work plan and to plan for suitable communication during the different stages of the internal auditing process.



LEARNING OUTCOMES

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

- advise on adequate communication techniques to be applied during the different phases of an internal audit
 - identify and comment on the different stages where communication and reporting is advisable or required during an internal audit
 - distinguish between different reporting techniques and apply suitable reporting techniques for different stages of the internal auditing process
 - document and report on the planning phase of an internal audit
-

Learning unit 15

Communication techniques

Contents

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Communication is required throughout the audit process. In the planning stage, the main purpose of communication is to gather information, to confirm the auditors' understanding of important aspects of the business and to obtain the cooperation and, if required, the approval of management for the audit. Internal auditors use different communication techniques during the planning and execution of the audit. Questioning and interviewing, the most popular communication techniques used to gather evidence, were discussed in topic 5.

Internal auditors also need to communicate their observations and findings to top management, departmental management, client staff and sometimes also outsiders. This is done by means of reporting. Reporting may be either informal or formal, verbal or written, interim or final and directed at different levels of authority, depending on the findings or observations that require reporting.

15.1 Negotiating

Internal audit engagements normally require close cooperation between the internal auditors and the staff of the organisation or activity being audited. It is also important for internal auditors to maintain good working relationships after the completion of audit engagements. What often happens in practice, however, is that the auditors and the operating personnel do not agree about particular aspects and need to reach an agreement by means of negotiation. It is therefore important for internal auditors to develop negotiation skills.

Negotiation is a basic means of getting what you want from others. It is a back-and-forth communication designed to reach an agreement when you and the other side have some interest in common and some interests in conflict. The negotiation process comprises three main phases – planning, conducting and following up.

Negotiating versus interviewing

An interview is conducted to obtain information from someone. It may not require the exchange of information, and it is unlikely that the view of the person from whom the information is being obtained will come into play. The purpose of negotiating, on the other hand, is to reach agreement on a particular issue. Negotiating is needed where the view of one party to the negotiation (usually management) differs from that of the internal auditor.

When is negotiation required?

Negotiation could occur at any stage of the process, for example when reaching agreement on

- the timing of the audit and reporting deadlines with the unit manager

- the standards of performance for audits with unit managers
- the findings, particularly the facts, impacts, causes and corrective action
- the dates for follow-up action
- the effectiveness of corrective action
- the final audit report

Internal auditors may also need to negotiate for things like access to computer terminals, documents, et cetera.

Recording the negotiation

Negotiations should be recorded on a working paper. This should be used to document the planning, conducting and following up of the negotiation.

Planning for negotiation

In negotiation, there are four possible results: win-win, win-lose, lose-win or lose-lose. The long-term objective of the internal auditor is usually win-win. The internal auditor wants to achieve the result he or she desires and at the same time achieve a result that is acceptable to the manager.

There is no point in entering into a lose-win negotiation where you do not achieve the desired results. A lose-win situation will only be acceptable where the manager is clearly negligent or reckless. A win-lose situation may be acceptable to the internal auditor; however, if the manager has lost a negotiation, he or she is unlikely to be favourably positioned towards internal auditors in subsequent negotiations. The objective in all negotiations should be to achieve a win-win situation.

In planning the negotiation, the internal auditor needs to ask four questions:

- What is the desired result of the negotiation?
- Who are the negotiators?
- When and where will we negotiate?
- How will we negotiate?

What is the desired result of the negotiation?

Skilled negotiators look at what they must achieve, what they intend to achieve and what they would like to achieve. For example, when discussing findings, the internal auditor must achieve corrective action on the high-impact findings, intends to achieve corrective action on the medium-impact findings, but would like to achieve corrective action on every finding.

What if a negotiated agreement cannot be reached? Successful negotiators plan this at the start of the negotiation: what is termed their BATNA, the Best Alternative To a Negotiated Agreement. For example, if the internal auditor cannot get corrective action agreed with a unit manager, the BATNA is to go to top managers to get them to take the necessary steps to force a unit manager to comply with the internal auditor's needs.

The internal auditor also needs to ascertain what the manager wants out of the negotiation. The internal auditor should ask the same questions: what must he or she achieve, what does he or she intend to achieve and what would he or she like to achieve? And what is his or her BATNA? Once the internal auditor's and the manager's desired results have been planned, the internal auditor can map the bargaining arena: the overlap between the internal auditor's desired result and the manager's desired result.

An agreement has to exist if a settlement is possible. A settlement is only possible if a bargaining arena exists.

Who are the negotiators?

The next step is to find out who the negotiators are on both sides. The internal auditor needs to know:

- How many negotiators will there be on a manager's side?
- What is their position in the organisational structure?
- What is their role in the organisation?
- Who will lead the negotiation?
- Who will summarise the results of the negotiation?
- Who will record the results of the negotiation?

Once these questions have been answered for managers, the same questions should be asked for the internal auditors.

■ How many negotiators?

Generally, the rule is the same number as represent the managers. Avoid a situation where one party, outnumbered at the negotiating table, feels intimidated. Only if the internal auditor needs to pressurise the manager through this strategy should the internal auditor try and outnumber the managers present.

■ Who should negotiate?

The higher up the manager in the organisation is, the higher up in the organisation the internal auditor should be. As far as possible, the internal auditor and the manager should be at the same level in the organisation. Where more than one negotiator will be present, it is important to decide who will lead the negotiation.

The internal auditor needs to decide who will summarise the negotiation. In negotiations, somebody needs to summarise the negotiation, recap and keep the negotiations on track.

Someone has to record the results of a negotiation; this could be a third person, the leader or summariser. In one-on-one negotiation, one person will have to play all three roles. The results of previous negotiations may be useful indicators as to what the internal auditors can expect.

One secret of successful negotiation is to match negotiating styles. The better planned the internal auditor, the more likely he or she is to achieve a favourable outcome.

■ When and where will we negotiate?

The internal auditor will usually take the initiative and set up a meeting. Timing is important. The internal auditor should fit in, as far as possible, with the manager's requirements. He should also fit in, as far as possible, with the manager's deadlines.

As to the location, there is a psychological advantage to the negotiator whose venue is used to hold the negotiation. For practical purposes, most audit negotiations will be held at the manager's offices. If the matter is particularly sensitive or there are other good reasons, neutral ground could be chosen.

■ How will we negotiate?

The internal auditor needs to know what issues are to be discussed in the negotiation, and in what sequence they will be dealt with. In assessing responses, the internal auditor should ensure that he or she has all the information needed for the negotiation. The negotiation is doomed to fail if the internal auditor has not prepared and does not have the necessary information.

The sequence of issues is important. It may be a good strategy to deal with the easier issues first. However, some issues may be so fundamental that the internal auditor wants to deal with those

first. The internal auditor should therefore plan the negotiation so that those issues that will not result in a time-consuming debate are discussed first.

Being prepared to counter the manager's viewpoint is an important part of the planning process. The internal auditor may want corrective action, but if he or she believes there will be an objection by the manager, he or she should be prepared to counter that. Negotiators who are properly prepared will win because it is likely that the other side will not have planned so well.

Conducting negotiations

The second phase of negotiation, conducting, has four steps:

- exploration
- bidding
- bargaining
- settling

■ Exploration

In the exploration phase, the internal auditor seeks to create common ground. There should be an opening statement explaining why the internal auditor is there. He or she should cover the areas to be covered during the negotiation, the desired results, the priorities of the negotiation, what will be the contribution for mutual benefit and the attitude of the negotiator.

■ Bidding

The internal auditor should open with his or her highest defensible bid. The bid should be firm and clear with no reservations or apologies. The internal auditor should then get the manager's response to the bid. If there is agreement, he or she can then go on to the next issue.

■ Bargaining

If agreement cannot be reached immediately, the negotiation then enters the bargaining phase. The internal auditor should ask the manager to clarify his or her bid. The internal auditor should only clarify his or her own bid if asked and in it answer the question. He should not offer justification. Justification may border on making excuses and it may appear as if the internal auditor is in a weak position.

Once the positions have been clarified, the situation should be assessed and alternatives considered. A new offer could be introduced or the deal changed. The internal auditor should be careful not to make any concessions unless they are matched by the manager. This process will be repeated until agreement is reached.

■ Settling

Settlement will be based on the bidding. The final offer will be made. This will be accepted and clarified as to what will happen next.

Following up on negotiations

The final phase is following up the negotiation to ensure that the desired outcome is achieved. The following up process will be based on the settlement. In most cases, the internal auditor should ratify this in writing: exactly what was agreed and an action plan about who does what, by when. The internal auditor should ensure that the manager completes his or her side of the bargain, but just as important, make sure that he or she completes what he or she agreed to do. If the internal auditor needs to change his or her actions for any reason, he or she should notify the manager.

Behaviour during negotiations

Negotiation is a skill that has to be learnt and then practised, thereby improving the skill.

■ Nonverbal communication

Focus on the elements of nonverbal communication, such as the need to ensure empathy and rapport with the manager. This requires an appropriate and professional attitude, a calm temperament, using the right words, body language, vocal variety and questioning techniques.

■ Perception

There is a crucial need when negotiating to understand and appreciate the perceptions of others. The internal auditor needs to appreciate the manager's perceptions as well as his or her own and tolerate this ambiguity. Agreement will never be reached unless the negotiators appreciate each other's point of view.

■ Word usage

There is more than one way of saying something. The skilled negotiator should try and match word for word, the type of word usage applied by the manager.

■ Body language

The internal auditor should watch the use of personal space: the more intimate a person is, the closer he or she will get to you. In evaluating body language, the internal auditor should not look at this in isolation, but see if it matches what is being said.

■ Questioning

Effective questioning is essential for effective negotiating. Open questions should be used; the internal auditor should avoid closed questions and leading questions. Multiple questions should be avoided, there will be too many questions for the manager to absorb and respond to.

Follow-up questions also lend clarity to discussion. It is critical to make sure that the internal auditor understands what the negotiator is saying. This they can do by summarising and asking such questions as: Am I correct in saying that?

■ Listening

The answer should be listened to and not just heard. The internal auditor should record the negotiation on a key point basis. The internal auditor should listen not only to how things are said and the way in which they are said, but to the actual content as well.

15.2 Reporting

As mentioned before, the process of conveying audit findings and observations to appropriate levels of management, staff and authorities is known as reporting. As you have learnt in the second level of your internal auditing studies, the fulfilment of the objectives of the internal audit activity is largely dependent on the quality of reporting. Effective reporting requires a lot of practise and skill. Audit reporting begins with observations about the audit and the internal auditor's recommendations for addressing any problems identified during the audit. These observations and recommendations emerge during the process of comparing what should be with what is. Whatever the results of this process, they will give the internal auditor something to report.

Different types of audits require different methods of reporting. Certain information may not be appropriate for disclosure to all report recipients, because it is privileged or proprietary or related to improper or illegal acts. Such information may, however, be disclosed in a separate report. If the conditions being reported on involve senior management, the report will only be distributed to the directors of the organisation or the audit committee.

Some conditions may necessitate the issuing of interim reports. Interim reports may be oral or written and may be transmitted formally or informally. Interim reports are prepared and issued while the audit is in progress. They may be used to communicate information that requires immediate attention, to communicate a change in audit scope for the activity under review or to keep management informed of the progress of the audit if it extends over a long period. The use of interim reports does not reduce or eliminate the need for a final report.

A formal, signed audit report should be issued at the end of every internal audit engagement. The effectiveness with which information is collected during the audit process obviously constitutes the basis for successful reporting.

If the audit has been correctly carried out, the audit findings will already have been discussed with interested members of staff and management by the time it is finalised and efforts will already have been made to rectify deficiencies in the system. In cases where audit findings have not yet been communicated to interested members of staff and management, verbal and written audit reports are used to persuade management to take corrective action. This method is suitable for audit projects that cover a short time span or for a general review type of audit, where there is not sufficient opportunity during the audit to convey the findings. In other circumstances, the auditors should announce their audit findings as they are generated.



STUDY

Study *Reding et al*, chapter 14.

15.3 Presentation

In some types of audit engagements, such as assurance engagements and operational audit engagements, the audit report is the audit team's opportunity to get management's undivided attention. It also gives them a chance to point out the benefits of the type of audit performed. In most cases, the internal audit report serves a twofold purpose, namely

- to communicate the results of the audit
- to persuade, and sound a call for action

The presentation of internal audit reports creates an opportunity for the internal auditors to market their activity within the organisation. Sufficient attention should therefore be paid to the presentation of audit reports.

By getting a clear understanding of the purpose of the presentation, the internal auditor has a better chance of achieving the main objective. Reasons for presenting internal audit reports may be one or more of the following:

■ Promoting two-way communication and feedback

Written reports do not allow for two-way, interactive communication between the writer and the reader. Neither do they allow the reader to give the writer immediate feedback on the content and to clarify and emphasise certain ideas. The presentation serves to check how effectively the information is understood.

■ Communicating an urgency and immediacy to the subject

The nature of the spoken word and its ability to communicate between the lines make it very persuasive when used effectively. Through nonverbal cues and the manner of the presentation, the internal auditor can communicate a great deal that could never be transmitted on paper. The oral medium allows direct expression of human feelings and emotions. Often, such feelings and emotions are the basis for the acceptance or rejection of ideas.

■ Enhancing the internal auditor's flexibility

With a written report, there is little opportunity to clarify the message or any unclear points contained in the report. This is due to some managers providing insufficient or late feedback on the internal auditor's report. Furthermore, it is often difficult for the internal auditor to convey all pertinent information gathered in an audit to the manager. Presentations, on the other hand, provide the internal auditor with the opportunity to clarify his or her findings and opinion based on the manager's reactions. The internal auditor who is perceptive of these reactions and adapts his or her position accordingly, is more likely to reach his or her goals.

■ Enhancing the internal auditor's credibility

Internal auditors become managers because of their ability to perform a job effectively. There are many success stories about the internal auditor who gained immediate visibility through an effectively handled presentation on an important subject. An internal auditor's organisation, preparation, decisiveness, articulateness and ability to handle different reactions in front of a group will provide managers with a good estimate of his or her leadership potential.

■ Facilitating group ownership and commitment

Presentations are generally given at meetings where a manager from a particular unit has an interest. The presentation allows for the kind of exchange necessary to create a group cohesiveness, ownership and commitment. If the group members have to carry out the corrective action, they will do so more effectively if they are involved in formulating the actions.

The presenting process

There are many commonalities between the report writing and presenting process. This should not be a surprise, as the only significant difference is the delivery method.

If the audit work is deficient, the presentation will be too. The secret to good reporting is good audit work. The better the quality of the working papers, the easier the presentation will be.

To be able to meet a wide range of expectations, it is essential to be organised. Thorough and complete planning will lay the foundations for success.

During the planning of the presentation, it is advisable to obtain the input of an internal auditor who has experience in presenting. He will provide guidance on the outline and structure of the presentation.

Remember that the internal auditor should not try to develop the perfect presentation in one go. He or she should split the process into its creative and logical components:

- preparing the outline
- structuring the outline
- preparing the draft presentation
- editing the draft presentation
- selecting the presentation method

These five steps are described in detail below.

Preparing the outline

The secret to a successful presentation is to plan in time, fully, thoroughly, and for success. Sixty percent of the effort should go into the planning stage.

To prepare effectively, the internal auditor should find a place and time where there will be no interruptions. He or she should have the information needed close at hand, and should have deadlines to work to based on the project deadlines.

The starting point for an effective presentation is knowing the following:

- who the recipients are
- what message needs to be communicated
- what action the internal auditor wants the recipient to take

It takes a great deal of planning and presentation skills to maintain the involvement, interest and attention of the managers during a presentation. Many presentations lack direction due to poor planning and presentation. The internal auditor must think about why he or she is presenting, what he or she wants to achieve and who the target audience is. The more the internal auditor can keep the managers' attention, the more receptive they will be to the presentation's message.

The first step is to find out as much as possible about the audience:

- Which managers will be present at the presentation?
- Do they all do the same type of job or are they from different units?
- Why are the managers attending the presentation?
- How much do the managers know about the contents of the presentation?
- What are their attitudes towards the audit findings and the internal auditors?
- Are there any chances that their attitudes may change?
- Who is the decision-maker among them and where does the power base lie?

The message conveyed during the presentation decides the action that managers will take. Therefore, it is important to decide the purpose of the presentation.

The "tell" purpose is most appropriate when the objective of the presentation is to give information accurately, completely and with clarity. This is when the internal auditor states important facts and findings related to the audit. Managers must first understand the information before they can make a decision about it.

Tell purposes are particularly appropriate in the following circumstances:

- when the managers already show a favourable reaction to the internal auditor's ideas and the objective is to clarify the information
- when the managers have little background or knowledge about the ideas being presented
- when the internal auditor has not been specifically asked to make a decision or recommendation, but simply to clarify all the alternatives so that all options are clearly understood

The "sell" purpose involves more persuasion not only to present information, but also to get managers to accept the ideas being communicated or to commit themselves to specific action. Sell purposes are most appropriate in the following circumstances:

- when the internal auditor is expected to present specific recommendations
- when a manager needs to know why such recommendations are being made
- when the internal auditor is recognised as an expert on the subject
- when the information relates to some specific changes or decisions being considered

The "resolve" purpose involves presentations that deal with decisions or recommendations that are expected to receive an unfavourable response. During a presentation of this sort, the internal auditor needs to be sensitive not to embarrass any managers. This type of presentation is used

- when the internal auditor must communicate bad news

- when the internal auditor anticipates unfavourable reactions
- when managers are knowledgeable on aspects relating to both sides of an issue or decision

Presentations by internal auditors rarely involve just one purpose. One purpose may be primary, but a presentation may involve all three purposes. When the presentation involves more than one purpose, it is helpful to decide on the primary and secondary purposes. For example, the primary purpose may be to gain acceptance for possible change (sell), and the secondary purpose to deal with staff resistance (resolve) (Barlow et al, 1995:378–380).

Structuring the outline

If the outline is in sufficient detail, it should provide sufficient information for key point notes and slides.

Structuring the presentation has the following advantages:

- It reduces anxiety as the internal auditor knows what is going to be said next and where key points are going to be stressed.
- It ensures that the presentation is management-oriented.
- It helps the internal auditor to present his or her findings and opinion logically.
- It enables the managers to follow the presentation easily.
- It provides a framework to fall back on if led astray.

The information should be structured clearly and logically. Managers are normally more receptive at the beginning of the presentation. Therefore, in structuring the presentation, the internal auditor should put the most important message first. The other items may then be presented in order of importance and must always be supported by sufficient information.

Presentations are usually structured in the following way:

- an initial outline of the theme: the introduction (including the most important message)
- development of the theme: the body
- summary of the theme: the conclusion, followed by a request for action and what should be done next

Source: (Barlow et al, 1995:380–381)

1. The introduction

The introduction has several clear and specific functions. The basis for any successful presentation is laid during the first five minutes. A good introduction gains favourable attention, motivates managers to want to hear more, specifies clearly what the subject matter is and establishes the credibility of the speaker. In delivery time, the introduction can take as much as 20% of the time of the total presentation.

A common presentation structure is the AIDA outline:

- A: win their **attention**
- I: arouse their **interest**
- D: create a **desire**
- A: stimulate **action** or **agreement**

Managers are not always ready when the presentation begins. To remove distractions and gain their attention, the internal auditor should choose a technique most appropriate to the subject and grab the managers' attention. To motivate the managers to listen, the internal auditor needs to tell managers why it is worth their while to listen. The opening words should create a first impression and should therefore summarise the main theme and spell out the main points in the body (Barlow et al, 1995:381).

2. The body

The body contains factual support for the purpose. It should include

- a statement of facts

- sufficient information to support the findings and opinion of the internal auditor
- a refutation of contrary views

There may be up to five main points: preferably only three. Information used to support the internal auditor's findings and opinion should be the strongest evidence available. Think quality, not quantity. If detailed information is needed to ensure that all managers have the same understanding, it should be done right after the introduction.

There are essentially two ways of conveying a point: clarifying it, or proving it. To clarify a point, the internal auditor should use definitions, short examples, comparisons or contrasts, explanations, illustrations, demonstrations and analogies. To prove a point, the internal auditor should use examples, statistics, expert testimony, illustrations and demonstrations (Barlow et al, 1995:381).

3. The conclusion

This is where the presentation should produce results: it is what the internal auditor would like the managers to take away with them. The purpose of the conclusion is to reinforce the main points and to have the managers accept them in line with the original objective. The conclusion should always tie in with the opening. It should leave no doubt about what the managers should do next. The finish should be forceful and confident. A weak, inconclusive or apologetic closing can kill even the best presentation (Barlow et al, 1995:382).

Preparing the draft and editing the presentation

Provide sufficient information to support the key points identified in the outline. The guidance given above on structuring the presentation should be used. The draft should flesh out the structure developed in the previous stage.

As with the writing of the report, the most important guidance is for the internal auditor to put himself or herself in the position of the audience of the presentation. Although the structure of a report is important, arguably the structure of a presentation is more important. The internal auditor has to capture the attention of the managers almost immediately, and hold it until the end. In editing the presentation, the internal auditor should consider the structure and detailed contents of it.

In editing, the internal auditor should consider the following questions:

- Have I considered the managers' needs?
- What benefits and values are there for the managers?
- What are the facts?
- Is the intended message coming through?
- Am I being honest?

If the internal auditor ignores possible objections, the presentation may fail (Barlow et al, 1995:382).

Planning the venue and equipment

The quality of a presentation could be negatively affected if the environment in which the presentation takes place is unfavourable to the process. The internal auditor should consider the following before the presentation:

- booking of the venue and equipment
- ensuring that the presentation room will be adequate, namely tables, chairs, lighting and air-conditioning
- ensuring that everybody can see the presenter and the various projected images
- arranging the tables and chairs to facilitate group discussion

- removing any superfluous equipment or furniture from the room
- setting up the apparatus and testing the various equipment beforehand

Source: (Barlow et al, 1995:382–383)

Using visual aids

Smell, touch and taste account for a mere six per cent, sound for 11 per cent and sight for 83 per cent of our learning intake. Information presented audiovisually is retained with greater accuracy for a longer period than information presented purely orally.

By introducing a visual aid, the internal auditor gives himself or herself props to talk from. This also acts as a reminder or prompt during the presentation. The props must be used professionally or managers remember the technical blunders as opposed to the presentation content. When preparing visuals, be conscious of time: the visuals do not deserve more time than the presenter.

When choosing the type of visual to use, the internal auditor should consider the venue and audience size in relation to the medium chosen, as well as his or her own preferences when doing presentations. Should the equipment or facilities fail to function beyond immediate repair, the presenter must be able to continue without the aids.

The following visual aids may be used:

- chalk board
- magnetic board
- flipchart
- films or videos
- slides
- overhead projectors

Source: (Barlow et al, 1995:383)

Giving the presentation

Before giving the actual presentation, it is advisable to have a dry run of the presentation for some of his or her fellow internal auditors.

Body language plays a key role in the impact of the presentation: 93 per cent of a message is nonverbal and only seven per cent is verbal. Of the 93 per cent

- 55 per cent is conveyed through body language
- 38 per cent through tone of voice, vocal inflection and other sounds

Source: (Barlow et al, 1995:383)

Verbal communication

Internal auditors should choose their words carefully. They should use, where applicable, short, simple words. Managers are not impressed by someone who, through the language he or she uses, tries to show how educated he or she is and this often clouds the issue. Active verbs are stronger and more direct than passive ones and therefore more powerful. Jargon should be used only when the managers know what the words used mean. Some other do's and don'ts are:

Do

- speak clearly
- use simple language
- speak slowly
- stress main points
- speak with confidence
- vary your speaking pace and tone of your voice
- use deliberate pauses discreetly

Don't

- speak monotonously
- speak too fast or too slowly
- shout
- pronounce words at the end of sentences too softly or articulate them poorly

Source: (Barlow et al, 1995:384)

Nonverbal communication

Interpersonal communication is not limited to verbal symbols. Movement and position of the body constitute an important component of the total message. Factors which play a role in the forming of those important few impressions are

- personal appearance
- neatness
- eye contact
- posture or stance
- gesturing

Source: (Barlow et al, 1995:384)

Working with visual aids

Aids should be numbered and neatly arranged in the correct order. The internal auditor should

- check that the screen is shaded from excessive light
- have a pointer readily available for referring to the aid
- make a simple illustration of a complex issue
- ensure that the slides are straightforward and easily understood
- resist the temptation to talk while the managers are trying to read the aid
- never divide the attention of the managers
- change transparencies when the projector is switched off
- ensure that the path of the image to the screen is not obstructed
- be familiar with equipment so that adjusting images does not waste time
- give the managers time to absorb the information on the slides

No matter what visual aids the internal auditor uses, the internal auditor is still the primary focus of attention. He or she is the primary vehicle of communication; everything else is just an aid to communicating the information effectively (Barlow et al, 1995:384).

The internal auditor should consider distributing notes prior to the presentation or handing out notes at the actual presentation.



Learning unit 16

Reporting required in the planning phase of the internal audit

Contents

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16.1 Communicating with the Auditee

As a preliminary step, for most types of internal audits, the internal auditors should meet with the management of the selected audit area and inform them about the planned audit. The meeting usually plays an important role in the subsequent course of the audit. At this meeting, the auditors should attempt to obtain the support and cooperation of the management of the particular department or activity for the performance of the audit. In operational audits, for instance, the best results are achieved when an audit control committee is appointed to take responsibility for the coordination of the audit project. This committee should be made up of members drawn from the management of the department, the staff of the department under audit and the internal auditors. One of the people in charge of the audited department should serve as the chairman of the committee. The reason is that any decisions taken by the audit control committee automatically enjoy the support of management and that the implementation of the proposals arising from the audit becomes a mere formality.

After the preliminary investigation has been completed, the auditors should meet again with the management of the selected area to submit their findings. In consultative and operational audits, the auditors should convey information regarding the focus areas on which the auditors will concentrate during the performance of the audit. The auditors may also submit their working programme to management for their insight and comment.

16.2 Communicating with the chief audit executive (CAE) and audit staff

Standard 2340–1: Engagement supervision requires that engagements must be properly supervised to ensure objectives are achieved, quality is assured and audit staff is developed.

Supervising the audit engagement includes that appropriate instructions should be given during the planning stage of the audit. The auditor responsible for the planning of the engagement should have sufficient discussions with the CAE to ensure that the objective of the audit is understood and that the planning is directed at achieving those objectives.

The auditor responsible for the planning of the audit should in turn also communicate with the auditors that will be responsible for performing the audit.

Such communications may take the form of meetings in person and in teams, engagement letters, instructions in the audit file and detailed audit programmes.



Learning unit 17

Planning for effective reporting on internal audit engagements

As discussed in learning unit 8.1, effective reporting is a crucial element of the internal audit engagement. Internal auditors should plan for effective reporting. One way to ensure that the internal audit activity meets its requirements in terms of reporting is to adhere to the Standards and to adapt the guidance provided in the Practice Advisories to its planning processes.



STUDY

Study the following sections in *Auditing Legislation and Standards*:

Standards 2400, 2410, 2420 and 2440.A2

Practice Advisory 2400–1: *Legal Considerations in Communicating Results*

Practice Advisory 2410–1: *Communication Criteria*

Practice Advisory 2420–1: *Quality of Communication*

Practice Advisory 2440.A2–1: *Communicating outside the Organisation*



ACTIVITY 17.1

Do the review questions 1 and 10 at the end of chapter 14 in *Reding et al.*



TOPIC SUMMARY

This topic discussed the different ways of auditor communication that should be considered during the planning phase of an audit. Not only does the auditor have to communicate with different stakeholders during the planning phase; he/she also have to plan for the specific type of feedback and reporting that will be required during the engagement as well as at the conclusion of the engagement.

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

- advise on adequate communication techniques to be applied during the different phases of an internal audit
- identify and comment on the different stages where communication and reporting is advisable or required during an internal audit
- distinguish between different reporting techniques and apply suitable reporting techniques for different stages of the internal auditing process
- document and report on the planning phase of an internal audit