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4. **C** is the best answer. Even though the other choices have merit, the primary reason for the internal audit function to consider the organization's strategic plan when developing the annual audit plan is to ensure that internal audit efforts align with and support the overall business objectives of the organization.
5. **D** is the best answer. It is important for the internal audit function to establish policies and procedures to guide the internal audit staff. However, substance is much more important than form. As a result, it is not necessary for these policies and procedures to be codified into a formal manual, but it is important for them to be established and effectively communicated to the staff in a way that is consistent with the size and complexity of the internal audit function.
6. **B** is the best answer. When planning and performing a consulting engagement, the scope and engagement objectives are defined and agreed upon with the customer. As a result, the CAE should discuss the scope limitation with the customer and together evaluate whether the engagement should continue. For an assurance engagement, the scope limitation would need to be evaluated for impact on the internal audit function's ability to achieve the defined engagement objective. If it is concluded that the problem makes the assurance engagement objectives unachievable, the engagement should be terminated and the scope limitation should be communicated to both management and the audit committee.
7. **B** is the best answer. All are responsibilities of the CAE as defined by the *Standards* except for overseeing the establishment, administration, and assessment of the organization's system of internal controls and risk management processes, which is management's responsibility.
8. **C** is the best answer. It is appropriate for the CAE to request a copy of the external audit plan for conducting the financial statement audit to assist in planning the annual internal audit plan, but it is not appropriate for the CAE to approve the external audit plan. That could impair the independence and objectivity of the independent outside auditor's work.

Discussion Questions

1. The IIA's Quality Assurance professional standards (Section 1300) apply to a fully outsourced internal audit function (service provider) in exactly the same form and content as an internal audit function that is contained in-house. How the board audit committee chooses to staff the internal audit function is not relevant when considering applicability of this or any other IIA professional standard. However, there could be various approaches taken by a service provider to evidence compliance with the Quality Assurance standards. As a result, the service provider must be subjected to the external assessment procedures of Standard 1312: External Assessments with the results of such assessment provided to the organization's audit committee.
2. Internal audit functions can be placed on an executive and/or senior management level. This enables the internal audit function to better maintain independence when evaluating management's assessment of the organization's system of internal control and the organization's ability to effectively achieve business objectives and manage, monitor, and mitigate risks associated with the achievement of those objectives. A major advantage



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associated with placing internal auditors at this level is their ability to act as consultants on initiatives and projects, taking advantage of the professional expertise possessed by the internal audit function. The positioning of the internal audit function affects the degree to which it can remain objective. Being positioned on a level with senior and/or executive management with direct access to the board audit committee gives the internal audit function greater independence and consequently greater objectivity. Board audit committee participation in the selection, evaluation, and dismissal of the CAE further enhances the CAE's ability to maintain organizational independence and minimizes the possibility of senior and/or executive management exerting undue influence on a CAE that would impact his or her ability to act without bias (individual objectivity). Internal audit functions can also be positioned lower in the organizational hierarchy. These internal audit functions are often asked to perform nonaudit activities such as quality assurance, compliance, operational, and/or other transaction processing activities.

Organizations that continue to position the internal audit function to perform primarily operational and other nonaudit activities, as previously mentioned, effectively render the function unable to provide management with an evaluation of the design adequacy and operational effectiveness of operational controls (risk management, control, and governance processes) since they lack the objectivity to independently evaluate the organization's operations and offer impartial suggestions for improvement. When deciding where to place the internal audit function, ideally, the function will be positioned high enough within the organization with direct access to the board audit committee to allow conformity with The IIA's requirements and recommendations.

3. There is not a definitive correct answer to this question.
 - a. A "yes" answer should emphasize the following points. The CAE is able and should opine, along with the CEO and chief financial officer (CFO), on adequate design and effective operation of the system of internal controls over financial reporting, effective and efficient operations, and compliance with applicable laws and regulations as part of a properly designed and implemented COSO-based internal audit function. However, for this to be practical and possible, the internal audit function should be designated with this responsibility by the board audit committee as part of the internal audit function's charter, along with allocation of adequate resources and authorization to discharge these duties. The CAE must design an internal audit plan to provide adequate audit coverage to allow for the independent validation of management's opinion on the systems of internal control, as well as provide adequate audit coverage to allow the CAE to jointly opine on the system of internal controls. The results of both, the independent validation of management's opinion and the CAE's independent opinion, should be reported to the audit committee as part of the internal audit function's formal reporting to senior management and the board audit committee.
 - b. A "no" answer should emphasize the following points. The CAE should not opine on the system of internal controls because that is management's responsibility as owners of the controls (both adequate design and effective operation). Since the CAE is not an owner, they have no responsibility for opining on the adequate design or effective operation of the systems of internal control. The internal audit function's role and responsibilities should be strictly limited to an independent evaluation of management's opinion. To also opine on the system of internal



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controls implicitly requires the CAE to assume "ownership" of, or "responsibility" for, the system of internal controls, which creates an inherent conflict of interest with the independent assessment of management's opinion. An additional valid point, though a weaker argument in nature, is to site the inability to opine on the system of internal controls due to inadequate resources or audit coverage to support providing an independent opinion.

Case Study

A primary and initial decision Pat needs to make is what strategy and approach should be taken to transition from the current structure and reporting model for the internal audit function and the end state Pat envisions. As stated in the case study, all key stakeholders (CEO, CFO, board audit committee chair and members) in the future success of the internal audit function have expressed support for Pat and Pat's vision for the department. It is also important to gain the support, respect, and trust of these stakeholders so Pat can effectively implement the vision over the next several months.

Ultimately, it will be important for the board audit committee and chair to see Pat as the organization's management liaison instead of the CFO. However, that is not mandatory under The IIA's professional standards. In fact, The IIA states it this way, "The chief audit executive should report to a level within the organization that allows the internal audit function to fulfill its responsibilities (Organizational Independence), as well as maintain an impartial, unbiased attitude and avoid conflicts of interest (Individual Objectivity)."

It is important for Pat to meet with the CFO in advance of the upcoming audit committee meeting and confirm that the CFO agrees with transitioning the liaison role to Pat and the time frame in which it is to be done. At this meeting, Pat should review the "minimum" reporting requirements of The IIA's professional standards and ensure any reporting requirements related to the organization's fiscal year and related reporting are on the meeting agenda. Pat and the CFO should come to mutual agreement regarding each other's roles at the committee meeting, keeping in mind that this is an ideal opportunity to begin the transition.

Pat and the CFO should also discuss and agree on the role and responsibilities associated with this liaison role. The CFO needs to understand and agree with Pat's approach and timing to responding to the audit committee chair's desire to "gain an understanding of the vision and direction for the internal audit function going forward." This can either be addressed at the meeting as a formal agenda item or during an "executive" session with the audit committee chair in advance of the meeting. This naturally creates an opportunity to allow Pat to begin assuming the liaison role with the audit committee chair sooner rather than later.

Pat and the CFO should consider Practice Advisory 2060-1, which makes the following clarifications regarding reporting to the board and senior management:

The chief audit executive needs to submit activity reports to senior management and the board periodically. Activity reports highlight significant engagement observations and recommendations and inform senior management and the board of significant deviations from approved engagement work schedules, staffing plans, and financial budgets; the reasons for the deviations; and action taken or needed.



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Significant engagement observations are those conditions that, in the judgment of the CAE, could adversely affect the organization. Significant engagement observations may include conditions dealing with irregularities, illegal acts, errors, inefficiency, waste, ineffectiveness, conflicts of interest, and control weaknesses.

Senior management and the board make decisions on the appropriate action to be taken regarding significant engagement observations and recommendations. Senior management and the board may decide to assume the risk of not correcting the reported condition because of cost or other considerations. The board needs to be informed of senior management's decisions on all significant observations and recommendations.

The CAE considers whether it is appropriate to inform the board regarding previously reported, significant observations and recommendations in those instances when senior management and the board assumed the risk of not correcting the reported condition. This may be necessary when there have been significant changes that affect the risk profile.

Ultimately, the CAE has the responsibility to "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" (Standard 2060: Reporting to Senior Management and the Board). The CAE evidences the completion of these professional responsibilities by periodically reporting the results of ongoing internal audit activities to senior management and the board audit committee during routinely scheduled meetings throughout the year.

In Pat's case, there should be collaboration with the CFO to provide a summary report to the audit committee at the upcoming meeting. The report can be presented by either Pat or the CFO, as long as Pat is comfortable the report is complete and accurate. Additionally, the CFO and Pat should also coordinate efforts to ensure any applicable risks and controls are included and addressed in this summary report. The summary report should consider the need and applicability of covering:

- Business Unit Monitoring and Risk Monitoring Reports.
- External Auditor Activity Reports.
- Key Financial Activity Reports.
- Risk Management/Activity Reports.
- Legal and Compliance Monitoring Reports.

Again, the actual report can be submitted or presented by either the CFO or Pat, but this is another opportunity for beginning the transition process sooner rather than later.

In addition to this information, a report is typically submitted to the board audit committee by either senior management or the CAE outlining the results of management's self assessment regarding the adequate design and effective operation of the organization's internal controls. At minimum, the internal audit function should independently assess the process that management underwent to come to their conclusions. Pat would need to confirm that these efforts have been completed and the CFO plans to report on such at the upcoming committee meeting.



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Review Questions

1. Positioning the chief audit executive (CAE) on a senior management level within the organization gives the internal audit function the visibility, authority, and responsibility to independently evaluate management's assessment of the organization's system of internal controls and assess the organization's ability to achieve business objectives and manage, monitor, and mitigate the risks associated with those objectives.
2. Standard 2000: Managing the Internal Audit Activity, states that "the chief audit executive must effectively manage the internal audit activity to ensure it adds value to the organization." Recognizing that the CAE is pivotal to a successful internal audit function, the interpretation to this standard outlines the role and responsibilities of the CAE stating that "The internal audit activity is effectively managed when:
 - The results of the internal audit activity's work achieve the purposes and responsibility included in the internal audit charter,
 - The internal audit activity conforms with the Definition of Internal Auditing and the *Standards*; and
 - The individuals who are part of the internal audit activity demonstrate conformance with the Code of Ethics and the *Standards*."
3. The CAE should report to a level within the organization that allows the internal audit function to fulfill its responsibilities (Organizational Independence). In contrast, internal auditors should have an impartial, unbiased attitude and avoid conflicts of interest (Individual Objectivity).
4. The advantage of using a top-down, risk-based approach to create the annual internal audit plan is that it allows the internal audit function to prioritize the audit entities (business units or processes) based on the potential of the risks inherent to those entities to impede the achievement of the organization's strategic objectives.
5. Key elements taken into consideration when determining how to manage the internal audit function resources include the organizational structure and staffing strategy, financial budget, the internal audit schedule and annual internal audit plan, the staffing plan, hiring practices, training and mentoring goals, career planning and professional development initiatives, and strategic sourcing and rightsizing philosophies.
6. Flat organization structures consist of internal auditors who all have more or less the same level of skills, experience, and seniority. Internal audit functions employing flat structures tend to be stable, highly knowledgeable, and very collaborative; however, they also tend to result in a higher cost base due to the higher salaries necessary to retain auditors who all have a high degree of knowledge and experience. Hierarchically structured organizations, on the other hand, include internal auditors with varying degrees of knowledge and experience. In these internal audit functions, internal auditors with less knowledge and experience report to internal auditors with more knowledge and experience. These internal audit functions can be more dynamic than flat functions due to the fact that positions are often rotating with internal auditors promoting into higher positions as those in higher positions move up in the function or into positions outside of the function. Due to their dynamic nature, however, hierarchically



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organized functions can experience frequent change that, if not managed, can threaten the efficient achievement of the internal audit plan.

7. Hierarchically structured internal audit functions often have a variety of positions, including:
 - **Staff auditor** or IT staff auditor. Staff auditors are responsible for performing the fieldwork on financial, operational, compliance, and information system engagements in accordance with the established audit schedule for the purpose of determining the accuracy of financial records, effectiveness of business practices, and compliance with policies, procedures, laws, and regulations.
 - **Senior auditor** or IT senior auditor (sometimes referred to as an in-charge auditor). In addition to the responsibilities listed above, senior auditors are responsible for the planning stages of an engagement, guiding staff auditors in their fieldwork, ensuring that engagement timelines are met, reviewing the working papers prepared by the staff auditors, assisting in the preparation of engagement communications, performing the wrap-up steps of the engagement, and evaluating the staff auditors' performance.
 - **Audit manager** or IT audit manager. Audit managers supervise and administer engagements in accordance with the established audit schedule. Additionally, audit managers assist in the development and maintenance of the annual internal audit plan and risk model for assigned areas, issue engagement communications, and supervise senior auditors.
 - **Audit director** or IT audit director. In larger internal audit functions, audit director positions may exist. In addition to the responsibilities listed above, audit directors assist with the development of the overall internal audit strategy and planning, including the presentation and review of the internal audit strategy, mission, charter, and plan with the audit committee and senior management. Audit directors also supervise audit managers and are responsible for hiring and terminating internal audit associates.
 - **Chief audit executive.** The CAE develops, directs, organizes, monitors, plans, and administers the internal audit plan and budget, as approved by the audit committee, for the purpose of determining the accuracy of financial records, effectiveness of business practices, and compliance with applicable policies, procedures, laws, and regulations. The CAE also directly supervises the internal audit management team (audit directors and managers), oversees the entire internal audit function, and approves the hiring and termination of internal auditors.
8. When communicating the annual internal audit plan to senior management and the board, the CAE must include the internal audit function's "plans and resource requirements, including significant interim changes . . . for review and approval" as well as "the impact of resource limitations" (Standard 2020: Communication and Approval).
9. Matters of mutual interest discussed during coordination efforts with independent outside auditors include:
 - a. Audit coverage.
 - b. Access to each others' audit programs and workpapers.
 - c. Exchange of audit reports and management letters.
 - d. Common understanding of audit techniques, methods, and terminology.
10. Responsibilities when reporting to the board audit committee include the internal audit function's purpose, authority, responsibility, and performance relative to its annual internal



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audit plan. Reporting also should include identified significant risk exposures and control issues, corporate governance issues, and other matters needed or requested by the board and senior management.

11. Risk mitigation specifically refers to the tactical efforts undertaken by line management and operational employees to either reduce risk exposures or exploit competitive opportunities (advantages) that manifest themselves in day-to-day operations. Risk management, on the other hand, refers to the administration and oversight processes typically performed by senior management to monitor efforts to minimize risk exposures or steps taken to exploit competitive advantages. These administrative procedures are designed to help establish a common language for use when considering possible risk events or scenarios. More concisely, risk management is a participatory process designed to identify, document, evaluate, communicate, and monitor the most significant risk events facing an organization requiring risk mitigation to achieve business objectives.
12. The five objectives of a risk management process are:
 - Risks arising from business strategies and activities are identified and prioritized.
 - Management and the board have determined the level of risks acceptable to the organization, including the acceptance of risks designed to accomplish the organization's strategic plans.
 - Risk mitigation activities are designed and implemented to reduce, or otherwise manage, risk at levels that were determined to be acceptable to management and the board.
 - Ongoing monitoring activities are conducted to periodically reassess risk and the effectiveness of controls to manage risk.
 - The board and management receive periodic reports of the results of the risk management processes. The corporate governance processes of the organization should provide periodic communication of risks, risk strategies, and controls to stakeholders.
13. The internal audit function can play an important role in "improving the ethical climate" of its organizational culture by periodically assessing the state of the ethical climate of the organization and the effectiveness of its strategies, tactics, communications, and other processes in achieving the desired level of legal and ethical compliance.
14. Standard 2110: Governance states that the internal audit function "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 organization;
 - Ensuring effective organizational performance management and accountability;
 - Communicating risk and control information to appropriate areas of the organization; and
 - Coordinating the activities of and communicating information among the board, external and internal auditors, and management."
15. The five key elements of a properly designed quality assurance program include:
 - The CAE is accountable for establishing (**Implementing**) a quality program designed to provide reasonable assurance to the various stakeholders of the internal audit function.
 - **Monitoring** should include ongoing measurements and analyses of performance metrics.



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- The CAE is responsible for evaluating and concluding on (**Assessing**) the quality of the internal audit function, which may require improvements to address any identified gaps.
 - Quality improvement efforts should include a communication process designed to facilitate appropriate modification of resources, technology, and processes (**Continuous Improvement**).
 - The CAE should share the results (**Communicate Results**) of external and, as appropriate, internal quality program assessments with the various stakeholders, such as senior management, the board, and external auditors.
16. The seven areas in which the use of technology can most enhance the management of the internal audit function are:
- Control self-assessment.
 - Risk assessment.
 - Data interrogation.
 - Automated working papers.
 - Automated monitoring tools.
 - Department administration.
 - Internet research.

Multiple-choice Questions

1. **D** is the best answer. "Monitoring risk mitigation" is not one of the key elements of a properly designed quality assurance program as defined by The Institute of Internal Auditors' (IIA's) *International Standards for the Professional Practice of Internal Auditing (Standards)*. "Monitoring quality programs" and "assessing quality programs" along with "implementing quality programs," "continuous improvement," and "communicating results" comprises the five key elements of a properly designed quality assurance program.
2. **A** is the best answer. This engagement would not impair the function's independence. Making recommendations on the design or enhancement of internal control activities is a responsibility of the internal audit function. It is management's responsibility to implement and own controls.
3. **B** is the best answer. The CAE is ultimately responsible for determining whether the objectives of an internal audit engagement have been successfully achieved. The CAE is pivotal to a successful internal audit function. As explained by the interpretation to Standard 2000: Managing the Internal Audit Activity, the CAE is responsible for properly managing the internal audit activity so that:
 - "The results of the internal audit activity's work achieve the purpose and responsibility included in the internal audit charter;
 - The internal audit activity conforms with the Definition of Internal Auditing and the *Standards*; and
 - The individuals who are part of the internal audit activity demonstrate conformance with the Code of Ethics and the *Standards*."