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binary (satisfactory or unsatisfactory; effective or ineffective) or rated using a grading system (red-yellow-green; 1-2-3-4-5). An "unsatisfactory" or "ineffective" evaluation is still referred to as positive assurance even though the internal auditor's conclusion is negative. In addition, an opinion can be qualified when the auditor wants to express an exception to his or her general conclusion. For example, the auditor might use language such as "satisfactory, with the exception of . . ."

16. Practice Advisory 2410-1: Communication Criteria states that all final engagement communications "are to contain, at a minimum, the purpose, scope, and results of the engagement." The *purpose* represents the engagement objectives, that is, why the engagement was conducted and what it was expected to achieve. The *scope* defines the activities included in the engagement, the nature and extent of work performed, and the time period covered. The scope also may identify related activities not included in the engagement, if necessary, to delineate the boundaries of the engagement. Results include observations, conclusions, opinions, recommendations, and action plans. The final engagement communications also may contain the auditee's responses to the internal audit team's conclusions, opinions, and recommendations.

17. 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 customer. Consulting engagements are, accordingly, much more discretionary in nature than assurance engagements. As indicated in the Glossary to the *Standards*, consulting services include "counsel, advice, facilitation, and training."

Multiple-choice Questions

1. A is the best answer. The first of the three tasks the internal auditor should complete is to determine the results being achieved, that is, the "what is" condition of the business process. The next task would be to determine the reasons for, or the causes of, the observed condition. The third task would be to determine how the performance of the process can be improved. The recommendations for improvement should be directed at remedying the causes of the observed condition.
2. D is the best answer. It is virtually impossible to audit effectively something that is not sufficiently understood. The success of any engagement ultimately depends largely on how well the internal audit team understands the auditee. The first thing the internal auditors must understand is the auditee's business objectives and assertions. The internal audit team also must identify and assess the business risks that threaten the achievement of the auditee's objectives, identify the controls that are most critical to reducing business risks to acceptably low levels, and determine whether the identified key controls are designed adequately to reduce risks, both individually and collectively, to acceptably low levels.
3. B is the best answer. A broken lock on a security gate is an example of a control deficiency. The potential that controls will fail to reduce a risk to an acceptable level is referred to as control risk, not inherent risk.
4. A is the best answer. During the planning phase of an engagement, the internal audit team focuses its attention on inherent risk, that is, the risk to the auditee in the absence of any

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actions management might take to reduce or otherwise manage identified risks. Risk assessment involves gauging both the impact of the risk (if it should occur) and the likelihood of the risk occurring. Expressing inherent risks in terms of causes and effects helps the internal auditor assess how big the potential problem is and how likely it is to occur.

5. C is the best answer. The internal audit team must determine whether identified key controls are designed adequately to reduce risks, both individually and collectively, to acceptably low levels, assuming that the controls have been placed in operation and are operating as intended. If the key controls are assessed as being adequately designed, the internal auditors must then test the controls to determine whether they are in fact operating effectively as intended.
6. A is the best answer. Determining that controls are designed adequately is necessary, but not sufficient, for reaching a conclusion regarding their effectiveness. To reach a conclusion regarding their effectiveness, adequately designed controls must be tested to determine whether they are operating as intended.
7. D is the best answer. The operations of the treasury function as documented during the last audit represent the "what is" condition of the function at that point in time. This would be an inappropriate criterion against which to judge current operations unless the internal auditor found no room for improvement in the function during the last audit and there have been no changes in the function since then. The other three answers represent appropriate "what should be" criteria for the internal auditor to use in evaluating current operations.
8. A is the best answer. "Due professional care calls for the application of the care and skill expected of a reasonably prudent and competent internal auditor in the same or similar circumstances" (Practice Advisory 1220-1). To fulfill their due professional care responsibilities, internal auditors must base their conclusions on sufficient appropriate evidence.
9. A is the best answer. Standard 2500.A1 states that "The chief audit executive must establish a follow-up process to monitor and ensure that management actions have been effectively implemented or that senior management has accepted the risk of not taking action."
10. C is the best answer. Consulting services are defined in the Glossary to the Standards as "Advisory and related client service activities, the nature and scope of which are agreed with the client, are intended to add value and improve an organization's governance, risk management, and control processes without the internal auditor assuming management responsibility. Examples include counsel, advice, facilitation, and training."

Discussion Questions

1. Inherent risk is the combination of internal and external risk factors in their pure, uncontrolled state, or the gross risk that exists, assuming there are no internal controls in place. Analyzing the potential effects of an inherent risk helps the internal auditor judge the size of the potential

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problem and whether further attention to the risk is warranted. Analyzing the potential causes helps the internal auditor judge the likelihood of the risk becoming a reality.

The internal audit team also must weigh the assessed risk levels against management's risk tolerance thresholds and decide whether risks are being managed appropriately. Risks assessed at levels within management's risk tolerance thresholds may be accepted at their assessed levels. Risks that exceed management's tolerance thresholds must be mitigated to an acceptably low level. Response options to mitigate risks include avoiding risks by disbanding the activities that give rise to them, sharing risks by transferring a portion of them to third parties (for example, an insurance company), or reducing risks by implementing controls designed to lower their impact, likelihood, or both.

2. a. Three potential adverse consequences of an accident at a four-way intersection:
 - Injuries to drivers, passengers, and/or pedestrians.
 - Damage to vehicles and/or property.
 - Lawsuits filed against the city.
- b. Three inherent risk factors that make an accident more or less probable:
 - The volume of vehicles and pedestrians at the intersection.
 - The visibility of the intersection to drivers as they approach it.
 - The speed at which vehicles are traveling as they approach the intersection.
- c. 1. The city could avoid the risk of an accident at a four-way intersection by building an overpass.
2. The city could reduce the risk of an accident at a four-way intersection by:
 - Installing stop signs or stop lights.
 - Posting reduced speed limit and/or warning signs.
 - Building speed bumps into the streets.

3. The first statement is true. Determining that controls are designed adequately is necessary, but not sufficient, for reaching a conclusion regarding their effectiveness. To reach a conclusion regarding their effectiveness, adequately designed controls must be tested to determine whether they are operating as intended.

The second statement is generally true. It typically does not make sense to determine whether a poorly designed control is operating as designed. There are circumstances, however, in which internal auditors gather and document errors that have occurred as a result of control deficiencies to support their conclusions that controls are ineffective. Additionally, there may be instances when internal auditors want to measure the impact of a control deficiency.

4. a. Expressing a conclusion known as positive (reasonable) assurance requires the strongest supporting audit evidence. Internal auditors express positive assurance when they conclude that, in their opinion, the auditee's controls are designed adequately and operating effectively. Such a conclusion can be expressed only if the internal auditors have gathered and assessed sufficient

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appropriate evidence to evaluate the design adequacy and operating effectiveness of all the key controls within the entire system of controls under audit.

- b. Other factors that the chief audit executive (CAE) should consider when deciding which of the three options is the most appropriate for a particular assurance engagement include:
 - The expectations of the audit committee and senior management, which should be reflected in the internal audit charter. For example, CEOs and chief financial officers (CFOs) of public companies in the United States that are required under the U.S. Sarbanes-Oxley Act of 2002 to opine on the effectiveness of their companies' systems of internal control may want strong support from their internal audit functions.
 - The relative importance of the auditee's controls to the organization's overall system of internal controls. The level of assurance that an internal audit function wants to provide for particular assurance engagement typically is directly related to the importance of the controls being assessed to the organization's overall system of internal controls.
5. a. The primary purpose of assurance services is to provide independent assessments, based on an objective examination of evidence, of an organization'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 organization'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 customer. Consulting engagements are, accordingly, much more discretionary in nature than assurance engagements.

Although the consulting engagement process includes the same steps as the assurance engagement process, each step may not be necessary for every consulting engagement and many of the steps may be conducted differently. However, the three major phases of the engagement — planning, performing, and communicating — are the same.

Case

- A. 1. The purpose of the internal audit engagement is to conduct an operational safety audit of the production facility's metal drill press unit. The specific objective of the engagement is to determine whether the drill press equipment is operated in compliance with the company's safety policies.

Note: This internal audit engagement involves the direct assessment of process performance regarding compliance with company policies. Since performance may be adversely affected by deficiencies in control design adequacy and/or operating effectiveness, the potential causes of suboptimal performance (that is, noncompliance with safety policies) include inadequacies in the design of the policies and/or ineffectiveness in implementing the policies.
2. Internal audit observation:

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Condition (the factual evidence the internal auditors found, the "what is," current state):
We noted during our operational safety audit of the production facility's metal drill press unit that:

- The drill press equipment was in relatively poor condition with little evidence of regular maintenance. Drill bits were not being replaced as they became dull and broken bits often were used because new bits were not kept in supply. Two of the 10 drill press machines were missing safety shields. Four of the knee switches were sticking in either the off or on position occasionally.
- Five of the 10 machine operators were not using protective ear plugs and four were not wearing safety glasses.

Criteria (the standards, measures, or expectations used in making an evaluation; the "what should be," correct state):

The company's safety policies pertaining to the production facility's metal drill press unit include the following provisions:

- Metal drill press equipment operators are required to wear safety glasses, ear plugs, and protective gloves.
- The drill presses are required to have a clear, plastic safety shield and a protected channel to safely feed the metal through the press.
- The drill is operated by a knee switch. The operator engages and disengages the drill by shifting his or her right knee.

Consequence(s) (the real or potential adverse effects of the gap between the existing condition and the criteria):

The realized and potential effects of the production facility's failure to operate the metal drill press equipment in compliance with the company's safety policies include:

- Five downtime injuries of drill press operators occurred in the last six months. The total downtime for the five injuries was 37 hours. In addition, two drill press operators experienced detectable hearing loss during the six-month period.
- Management estimates that the downtime incurred, and the resultant decrease in overall productivity, reduced revenue by approximately US \$265,000. The employee injuries described above also may have resulted in avoidable medical expenditures and increased safety insurance premiums. These injuries may precipitate employee lawsuits against the company. Failure to fix the safety hazards will further damage the company's operations and financial performance.
- The unsafe working conditions in the production facility may represent violations of safety laws and regulations that could result in sanctions, fines, and/or other penalties.
- The company may be exposed to adverse publicity about the unsafe working conditions in the production facility that, in turn, will harm the company's reputation.

Cause(s) (the underlying reasons for the gap between the expected and actual condition, which lead to the adverse consequences):

The following causes of the unsafe working conditions in the production facility's metal drill press unit came to our attention during our operational safety audit:

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- Although the company's safety policies prescribe appropriate safety features to prevent employee injuries, they do not include any provisions for equipment maintenance aimed at ensuring the safety features are implemented properly and operating effectively.
- There appears to be a general lack of concern about safety among production management personnel, drill press equipment operators, and maintenance employees.

B. The internal audit observation presented in A.2. above is at least "reportable" and most likely "significant." There is not enough information given in the problem to determine for sure whether the known and potential financial harm caused by the safety hazards is, by itself, significant to the company as a whole. However, senior executives and boards of reputable companies do consider employee injuries of a serious nature to be significant in and of themselves. They also want to address, in a timely manner, the impact such injuries may have on the company's reputation. For these reasons, the internal audit function should deem this observation important enough to communicate to senior management and the audit committee.

C. **From:** AFR Manufacturing Company's Chief Audit Executive

Sent: Friday, September 11, 20XX, 5:10 p.m.

To: AFR Manufacturing Company's Chief Operating Officer

Subject: Proposal to Provide Production Facility Safety Consulting Services

Our recent operational safety audit of the production facility's metal drill press unit resulted in the attached observation, which we communicated to you, other members of senior management, and the audit committee. Per our discussion on Wednesday, September 9th, we agreed that Corporate Audit provide the following consulting services:

Phase 1: Provide Advice Regarding the Company's Production Safety Policies and Procedures.

The first phase of the consulting engagement would be to review the company's production safety policies and procedures and provide recommendations for improving the prescribed policies and procedures in a manner that will enhance our production employees' safety. One example of the safety matters the recommendations will address, which is based directly on the outcomes of the operational safety audit of the production facility's metal drill press unit, is the inclusion of policies and procedures for regularly scheduled equipment maintenance aimed at ensuring that prescribed safety features are implemented properly and operating effectively.

Phase 2: Provide Production Facility Safety Training. The second phase of the consulting engagement would be to assist your office in providing training on the revised production safety policies to all production personnel. The training would cover:

- Senior management's philosophy regarding safety.
- The reasons why compliance with prescribed safety policies is important and the potential adverse consequences of noncompliance.
- The revised policies and procedures.
- How the revised policies and procedures will be reflected in the company's compensation and incentive plans.



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- Any concerns or questions regarding the revised policies and procedures that production personnel may have.

Thank you very much for your interest in this proposed consulting engagement. Please let me know when you are ready to discuss the proposal in more depth. I look forward to meeting with you again in the near future to plan next steps.

Copies to:

AFR Manufacturing Company's Chief Executive Officer
AFR Manufacturing Company's Chief Financial Officer
AFR Manufacturing Company's Audit Committee Chair