

Review Questions

1. Communication is an integral part of an assurance engagement because final communications formally document all of the observations related to the area subject to the audit, the action plan for remediating the observations, and a plan for following up to ensure the plan is implemented and operating as intended.
2. Communication to auditees directly relates to the chief audit executive's (CAE's) communication to senior management and the board because assurance engagements, in part, evidence the internal audit function's independent assessments of how effectively the organization's risks are mitigated. These individual assessments, when taken in the aggregate, help support senior management's assertions regarding the design adequacy and operating effectiveness of the organization's system of internal controls.
3. The steps to address an observation include:
  - Determining the Committee of Sponsoring Organizations of the Treadway Commission (COSO) category (effectiveness and efficiency of operations, reliability of financial reporting, or compliance with applicable laws and regulations).
  - Classifying the observation in terms of assessing the applicable control as ineffectively operating or inadequately designed.
  - Determining the impact and likelihood of the observation.
  - Assess whether the observation is insignificant, significant, or material in importance.
4. Interim and preliminary communication is important because the auditee must be made aware, throughout the engagement, of any observations that the internal audit function has identified so that he or she can respond as to the accuracy of the facts related to the observation as well as the best course for remediation. Additionally, interim communication allows the auditee to address identified observations as soon as they are known as opposed to waiting for the final communication.
5. The closing conference (also referred to as an exit conference) allows the internal audit function to confirm the preliminary facts relative to any observations indicated by testing done during the assurance engagement with the appropriate management representatives of the area that was audited prior to distribution of the final engagement communication. It also allows all parties to review the form and content of what is anticipated to be included in the final (formal and informal) audit engagement communications and provides an opportunity for any misunderstandings to be resolved. Additionally, it provides management of the targeted functional areas a way to present their thoughts and planned actions regarding the items to be covered in the final engagement communication and to give feedback regarding how well the engagement team executed the assurance engagement. Management's action plan to address and resolve control weaknesses identified during the assurance engagement is also agreed upon in the closing conference. This provides another check point on the completeness and accuracy of the draft final communication prior to distribution to management representatives of the area that was subject to the assurance engagement.
6. The four attributes that must be present for each observation in an assurance engagement communication are: Criteria, Condition, Cause, and Effect. Typically, a well articulated observation

will include a detailed recommendation and management's response (action plan to address and resolve identified control weaknesses).

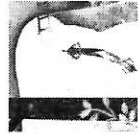
7. The internal audit function must have a process in place to monitor and follow up on agreed-upon actions to ensure management has done what they intended. If management chooses to accept the risk associated with making no changes to the control activity, The Institute of Internal Auditors' (IIA's) *International Standards for the Professional Practice of Internal Auditing (Standards)* indicates that the CAE must make a judgment regarding the prudence of that decision. Furthermore, "when the chief audit executive believes that senior management has accepted a level of residual risk that may be unacceptable to the organization, the chief audit executive must discuss the matter with senior management. If the decision regarding residual risk is not resolved, the chief audit executive must report the matter to the board for resolution" (Standard 2600). If, on the other hand, management accepts responsibility for implementing changes to remediate the observations, the internal audit function must monitor the progress management makes relative to the remediation of the observations. Regular follow-up procedures should ensure that agreed-upon actions are taken on schedule with the time frame outlined in the final engagement communication. Ultimately, it is the CAE's responsibility to "establish and maintain a system to monitor the disposition of results communicated to management" (Standard 2500). This system should be delineated in the internal audit function's written policies and procedures. At a minimum, follow-up actions should be documented and retained in the internal audit function's working papers of the next assurance engagement relating to the area that was subject to the original audit. Additionally, in the case in which engagement observations were evaluated as significant or material, another audit, commonly referred to as a "follow-up" engagement, is typically scheduled with a targeted scope to evaluate and test whether the residual risk of the targeted area has been reduced to an acceptable level. This engagement should be planned, executed, and reported on in a manner consistent with any other assurance engagement. In terms of communication, the internal audit function has the responsibility to communicate the outcome of the targeted review of residual risk to the same audience that received the communication from the original assurance engagement that resulted in the significant or material observations. Additionally, when the controls that were assessed to be significantly or materially compromised in the original assurance engagement communication represent internal control over financial reporting, communication must be provided to other interested parties as defined by reporting requirements dictated by financial reporting laws in the countries in which the organization operates.
8. Informal communication is considered appropriate only when, during the observation evaluation and escalation process, all observations were assessed to be insignificant with no key control activities compromised. The informal communication will cover insignificant observations related to secondary control activities that might be compromised and will only be distributed to management representatives of the area that was the target of the audit. Formal communications are assurance engagement communications for which the intended recipient is senior management, the audit committee, the organization's independent outside auditor, and/or management to whom the key individuals within the area that is the subject of the audit report. Formal communications are indicated when the controls evaluated during an assurance engagement are assessed to be: significantly compromised with key control activities affected, significantly compromised, or materially compromised. Every assurance engagement, no matter if there are observations to report or



- not, must result in a final, formal communication for the internal audit function to fully discharge its responsibilities as outlined in the *Standards*.
- All final (formal and informal) communications should include the following information: the purpose and scope of the audit, the time frame of the audit, the observations and recommendations (results) of the audit, the conclusion (opinion or rating, if applicable) of the internal audit function, and management's response (action plan) to the recommendations.
  - The internal audit function's assessment of controls that is included in the final engagement communication can be stated either positively or negatively. If an internal audit function chooses to state that the controls are designed adequately and operating effectively, it has given positive assurance. If, on the other hand, the internal audit function chooses to communicate that nothing has come to their attention that leads them to believe that the controls are not designed adequately and operating effectively, it has given negative assurance.

#### Multiple-choice Questions

- A is the best answer. Recommendations represent options that are available to management. Problems must be resolved in the manner deemed appropriate by management, not the internal audit function. Providing recommendations may enable management to reduce the costs/time of addressing audit findings, but there is no guarantee of this.
- D is the best answer. Audit reports should communicate observations and recommended courses of action. An engagement client should have an opportunity to respond before the report is distributed in its final form. The internal audit function makes recommendations and does not submit requirements. Where appropriate, the independent outside auditor would review working papers to accomplish this end.
- C is the best answer. Practice Advisory 2410-1 states that final engagement communications should contain, at a minimum, "the purpose, scope, and results of the engagement." Background information and summaries are not required elements of a final engagement communication.
- C is the best answer. Identifying concerns for future engagements is not a primary objective of the closing conference. Resolving conflicts, discussing the engagement observations to reach agreement on the facts, and determining management's action plan and responses are all objectives of the closing conference.
- C is the best answer. This represents a change in process that should be brought to the attention of management and documented. The procedures in answer A do not represent a deficiency since efficiency has improved without diminishing control. The flowchart in answer B is not the best form of documentation because it does not address efficiency. Answer D is incorrect because the engagement should be completed.
- D is the best answer. A formal communication must report significant observations. Documenting the auditee's response is optional. The corrective actions in a communication are recommendations and senior management is not required to remediate observations using the internal audit function's recommendations. Formal engagement communication does not provide a means by which the independent outside auditor assesses reliance on the internal audit function.



- A is the best answer. The CAE should consider the significance of the observation and the degree of effort and cost needed to implement the corrective action when determining the extent of follow-up. Neither the CAE's past experience with the manager charged with the corrective action nor the experience of the internal audit staff are relevant.
- C is the best answer. "Advances are not to exceed estimated expenses for 45 days" represents the criteria. "Travel advances exceed prescribed maximum amounts" represents the condition. The excerpt of the observation does not mention unauthorized employees given travel advances.
- D is the best answer. Suggesting practical improvements to address identified observations will most likely motivate management to correct deficiencies. The other answers, if implemented, are likely to make management defensive rather than motivated.
- A is the best answer. While interim communication can set the stage for the final report and keep management informed of the status of the audit, the primary purpose is to provide management the opportunity to act on certain observations immediately. Interim communication is not intended to describe the scope of the audit.

#### Discussion Questions

- The observation evaluation and escalation process requires the following:
  - An internal audit team must make judgments as they evaluate factors affecting the observation relative to its impact, likelihood, classification, and the way in which it affects the mitigation of risk. The internal auditors must also determine the cause of the observation, specifically, whether the control in question is designed inadequately or operating ineffectively.
  - An individual observation, or a group of observations, is considered insignificant if the control in question has a remote likelihood (slight chance) of failing or the impact of its failure is insignificant (trivial). An individual observation, or a group of observations, is considered significant if the control in question has a more than remote likelihood of failing and the impact of its failure is more than insignificant (that is, significant). An individual observation, or a group of observations, is considered material if the control in question has a more than remote likelihood of failing and the impact of its failure is not only more than insignificant, but also exceeds the financial statement materiality threshold (or other established thresholds for materiality).
  - Documentation of the conclusions reached as a result of performing the observation evaluation and escalation process is essential to evidencing that the internal audit function has appropriately determined how and to whom to communicate observations indicated by the test results of the assurance engagement.
- Management makes one of two choices: either implement changes to address the observation or accept the risk associated with making no changes to the control. If changes are implemented, the internal audit function must have a process in place to monitor and follow up on agreed-upon actions to ensure management has done what they intended, and the actions appropriately addressed the observation. If management chooses to accept the risk, the *Standards* indicates that the CAE must make a judgment regarding the prudence of that decision. Furthermore, "when the chief audit



executive believes that senior management has accepted a level of residual risk that may be unacceptable to the organization, the chief audit executive must discuss the matter with senior management. If the decision regarding residual risk is not resolved, the chief audit executive must report the matter to the board for resolution" (Standard 2600: Resolution of Management's Acceptance of Risk).

3. Observation: Fraud has been perpetrated and covered up by a senior manager who is in a position to circumvent controls. This observation affects COSO categories "Effectiveness and Efficiency of Operations" and "Reliability of Financial Reporting." The observation is a result of both inadequate design and ineffective operation of the related controls. This operation represents a significant deficiency for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be more than inconsequential, but less than material, because the year-end adjustment was not material to the company as a whole even though material to the store. As indicated in paragraph 140 of Auditing Standard 2, "Identification of fraud of any magnitude on the part of senior management" is automatically a significant deficiency by definition. This significant deficiency must be formally communicated in a final assurance engagement communication to senior management, the audit committee, and the organization's independent outside auditor.

4. Many internal auditors believe a rating system is valuable as it provides a way for management and the audit committee to compare the results of assurance engagements across functional areas within an organization, as well as a means to trend audit results for a specific area over time. Internal auditors typically spend a great deal of time reviewing an area, and in longer reports it can be difficult for the reader to fully understand the aggregate magnitude of the findings. A rating helps to provide that perspective. On the other hand, some internal auditors would prefer not to include ratings in engagement reports as they believe it may result in antagonistic relationships between the internal audit function and the rest of the organization if they distribute communications that rate areas or processes as less than satisfactory.

5. Based on the information provided, students' answers should be similar to the following:

- The type of opinion the CAE gives in this situation is positive assurance because the communication provided positively states that "internal controls over operations, financial reporting, and compliance are designed adequately and operating effectively." Negative assurance would merely state that nothing had come to the CAE's attention that indicates the controls are not designed adequately and operating effectively.
- The opinion presented implies that the CAE is relying on the work completed in the annual internal audit plan, including the results of the annual risk assessment performed by executive management as part of their enterprise risk management process as well as the risk assessments of both the internal audit function and the organization's external auditors. Additionally, it implies coverage of "internal controls over all three COSO categories (operations, financial reporting, and compliance).
- The CAE should take several factors into consideration before taking on this responsibility. The internal audit function should be designated with this responsibility by the audit committee, not just the audit committee chair. Also, this responsibility should be included as part of the internal audit function's charter and adequate resources should be allocated to allow the internal audit



function to discharge these duties. Furthermore, the CAE must design the annual internal audit plan to ensure it provides 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 entire system of internal controls, that is, all three COSO categories. Finally, the CAE should take steps to ensure that the internal audit function's opinion given on the overall system of internal controls is consistent with the internal audit function's aggregate assessment of the individual areas that comprise the organization's system of internal controls.

### Case

Because the process in question is accounts payable, which directly impacts the accuracy and reliability of the organization's general ledger and related financial statements, the affected COSO category is "Reliability of Financial Reporting." There can also be a case made for the observations relating to "Effectiveness and Efficiency of Operations" as an additional COSO category affected since the process in question also relates to the operations of the accounts payable department.

With respect to classifying each observation in terms of its design adequacy and operating effectiveness, the following is indicated:

- Inadequate segregation of duties over certain information system access controls — **Inadequate Design**
- Several instances of transactions that were not properly recorded in subsidiary ledgers — **Ineffective Operation**
- A lack of timely reconciliations of the account balances affected by the improperly recorded transactions — **Ineffective Operation**

The individual observations would be classified as **significant deficiencies** since there is a reasonable possibility that each deficiency will result in a misstatement that is significant, but less than material.

The conclusion also should be drawn that the aggregation or combination of these significant deficiencies represents a **material weakness** for the following reasons: Individually, there is a reasonable possibility that each deficiency will result in a misstatement that is significant, but less than material. However, each of these significant deficiencies affects the same set of accounts and financial reporting process or subprocess. Taken together, there is a reasonable possibility that a material misstatement could occur and not be prevented or detected.

Communication must be formal and include senior management, the organization's independent outside auditor, and the audit committee. Additionally, since the observations relate to internal control over financial reporting and, in the aggregate, were considered a material weakness, financial reporting regulations in many countries require management to qualify their overall opinion on internal control over financial reporting and formulate a remediation plan to correct the weaknesses identified in the controls in question. Depending on the specific regulations for the country in question, management may need to continue to qualify its opinion on internal control over financial reporting until the material weakness is remediated and management has verified such through control retesting that indicates the applicable



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controls are adequately designed and effectively operating. In many countries, financial reporting regulations will also require management to report their qualified opinion on internal control over financial reporting to its shareholders in the appropriate documents as dictated by the applicable regulations.

