

**MO001/3/2015**

**The Internal Audit Process: Specific Audit  
Assignments And Reporting**

**AUI3703**

**Semesters 1 & 2**

**Department of Auditing**

**IMPORTANT INFORMATION**

This document contains important information  
about your module.

BAR CODE

## ***Contents***

### **STUDY OVERVIEW**

#### **Part A CONDUCTING SPECIFIC INTERNAL AUDIT ASSIGNMENTS AND REPORTING ON COMPLETED AUDIT PROJECTS**

TOPIC 1: International Standards for the Professional Practice of Internal Auditing

#### **Part B SIGNIFICANT FACTORS IMPACTING ON CONDUCTING SPECIFIC AUDIT ASSIGNMENTS**

TOPIC 2: Nature of and legislature pertaining to specific audit assignments

#### **Part C CONDUCTING SPECIFIC AUDIT ASSIGNMENTS**

TOPIC 3: Performance Auditing

TOPIC 4: Fraud Auditing

TOPIC 5: Information Systems Auditing

TOPIC 6: Various Consulting Engagements

#### **Part D REPORTING AND FOLLOW UP ON THE COMPLETION OF AUDIT PROJECTS**

TOPIC 7: Reporting and Follow-up on the completion of audit assignment




## STUDY OVERVIEW

Every human being has certain objectives in life. Being the manager of your life, you would have set certain **objectives** for yourself. Being registered for this module indicates that one of your objectives is to obtain a degree at Unisa. Since this is a third level module, you should be aware of the **risks** that may keep you from reaching this objective, such as








- not having adequate time to study
- not being able to pay for your studies
- falling ill and not being able to study and/or write the exam






Having reached this level of study also indicates that you have implemented adequate **controls** to keep these risks from manifesting.

Let's think of possible controls you may have implemented:

Risks	Controls
 not having adequate time to study	<ul style="list-style-type: none"> <li>• Diarise deadlines for assignments and plan time to complete them</li> <li>• Arrange adequate study leave in advance to prepare for exams</li> <li>• Limit social activities to weekends only</li> </ul>
 not being able to pay for your studies	<ul style="list-style-type: none"> <li>• Make sure you pass, so that your sponsors will be willing to continue paying for your studies</li> <li>• Be a diligent and reliable worker so that you will continue to earn money to pay for your own studies</li> <li>• Restrict yourself to a budget so that you will have money to pay for your studies</li> </ul>
 falling ill and not being able to study and/or write exam	<ul style="list-style-type: none"> <li>• Eat healthy</li> <li>• Get enough sleep</li> <li>• Exercise frequently</li> </ul>

The ultimate proof to yourself that you have implemented adequate controls will be to receive positive results at the end of the semester. However, if you are wise enough, you will perform interim **tests of the controls** on the controls you have implemented to provide assurance to yourself that the controls are working. By testing the controls you will be able to assess whether or not the controls you have implemented are working as intended or whether additional controls or adjustments to the existing controls may be necessary. How would you test the adequacy of these controls?

Risks	Controls	Tests of controls
	<ul style="list-style-type: none"> <li>•  Diarise deadlines for assignments and plan time to complete them</li> <li>•  Arrange adequate study leave in advance to prepare for exams</li> <li>•  Limit social activities to weekends only</li> </ul>	<ul style="list-style-type: none"> <li>• Confirm with your work and friends that you have diarised all commitments and that you still have time to complete the assignments as planned</li> <li>• Obtain written approval of your leave arrangements from management</li> <li>• Page through your diary and reflect on your time management for the two recent and two coming weeks to ensure that you are not engaging in social activities during the week</li> </ul>
	<ul style="list-style-type: none"> <li>•  Make sure you pass, so that your sponsors will be willing to continue paying for your studies</li> <li>•  Be a diligent and reliable worker so that you will continue to earn money to pay for your own studies</li> </ul>	<ul style="list-style-type: none"> <li>• Check on myUnisa that the university has received your assignments before the cut-off date and that you have admission to the exams</li> <li>• Discuss your performance with your supervisor/manager and find out if he or she is satisfied or how you can improve</li> </ul>

	<ul style="list-style-type: none"> <li>•  Restrict yourself to a budget so that you will have money to pay for your studies</li> </ul>	<ul style="list-style-type: none"> <li>• Check your expenses against your budget and make sure you keep within the limits set for yourself</li> </ul>
	<ul style="list-style-type: none"> <li>•  Eat healthy</li> <li>•  Get enough sleep</li> <li>•  Exercise frequently</li> </ul>	<p>From time to time, reflect on</p> <ul style="list-style-type: none"> <li>• when last you had a decent meal</li> <li>• what time you have been going to bed</li> <li>• when last you got exercise</li> </ul>

This module is all about the application of the fundamental internal auditing principles and techniques which are normally considered and applied while performing specific audit assignments and the reporting thereof at the completion of an audit. As you have seen in the example above, controls do not apply to financial systems only; controls are developed to mitigate and manage the risks that threaten the achievement of objectives. Financial risks are one of many categories of risks organisations face. Other risks may be categorised as operational risks, compliance risks, and environmental risks and so on. Testing (or auditing) the controls aimed to mitigate those risks is covered in this module.

To be able to better understand this module, you need to have passed the second level module AUI2601: *Internal Auditing – Theory and Principles*.




The module starts out with a discussion of internal auditing and other guidance as well as best practices with regard to specific audit assignments. It then goes on to discuss how these specific assignments should be conducted and finally how to report the results of such testing.









## THE ICONS FOR ACTIVITIES USED IN YOUR STUDY MATERIAL



Each study 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 learning guide and tutorial letter are listed below, together with a description of what each of them means.

Icon	Description
	<b>Key concepts.</b> The key concepts icon draws your <b>attention</b> to certain keywords or concepts that you will come across in the topic or study unit.
	<b>Learning outcomes.</b> The learning outcomes indicate what parts of the topic or study units you have to master and demonstrate that you have mastered.
	<b>Mind map.</b> Mind maps are provided to help you to see the relationship between various parts of the learning material.

	<p><b>Study.</b> The study icon indicates which sections of the prescribed book or the learning guide you need to study and internalise.</p>
	<p><b>Read.</b> The read icon will direct you to read certain sections of the prescribed book for background information.</p>
	<p><b>Activity.</b> The activity icon refers to activities that you must do in order to develop a deeper understanding of the learning material.</p>
	<p><b>Reflection.</b> The reflection icon requires you to reflect on the important issues or problems dealt with in the study unit.</p>
	<p><b>Assessment.</b> When you see the assessment icon you will be required to test your knowledge, understanding and application of the material you have just studied.</p>
	<p><b>Feedback.</b> The feedback icon indicates that you will receive feedback on your answers to the self-assessment activities.</p>
	<p><b>Multimedia.</b> The multimedia icon indicates that you have to refer to any audio, video, DVD material that may be included in your study material.</p>
	<p><b>Time-out.</b> The time-out icon indicates that you should take a rest because you have reached the end of a study unit or topic.</p>

## STUDY SOURCES

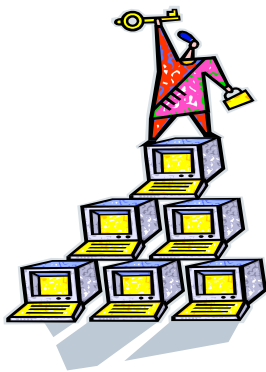
The study material for this module comprises the discussions and explanations contained in this study guide and tutorial letters, as well as those contained in the following prescribed books:

- Reding, KF, Sobel, PJ, Anderson, UL, Head, MJ, Ramamoorti, S, Slamasick, M & Riddle, C. *Internal auditing: assurance & consulting services*. Altamonte Springs, FL. The Institute of Internal Auditors Research Foundation. (Latest edition.) (Hereafter referred to as **Reding et al**)
- *Auditing legislation and standards*. Durban: LexisNexis Butterworths. (Latest edition.)



# **PART A: CONDUCTING SPECIFIC INTERNAL AUDIT ASSIGNMENTS AND REPORTING ON COMPLETED AUDIT PROJECTS**

## **TOPIC 1: INTERNATIONAL STANDARDS FOR THE PROFESSIONAL PRACTICE OF INTERNAL AUDITING**



### **INTRODUCTION AND PURPOSE OF THE TOPIC**

In this study unit we present the International Professional Practices Framework (IPPF) for internal auditing, and the purpose and relevance of the standards.

The IPPF was developed to:

- describe the basic principles that ideally represent the practice of internal auditing
- provide a framework for performing and promoting a broad range of value-added activities
- establish the basis for measuring internal audit performance
- help foster improved organisational processes and operations through continuous improvement



## LEARNING OUTCOMES

**After you have studied this topic, you should be able to:**

- discuss the usefulness and principal function of professional guidance
- advise on principles that are relevant to the profession and practice of internal auditing
- discuss and criticise the behaviour norms expected of internal auditors

## CONTENT OF THE TOPIC

**The following study units will be covered in this topic:**

Study unit	Title
1.1	IIA Code of Ethics
1.2	International Standards for the Professional Practice of Internal Auditing (Standards)
1.3	Other guidance impacting on specific internal audit assignments

## STUDY UNIT 1.1: IIA CODE OF ETHICS



### 1.1.1 INTRODUCTION

The code of ethics of the IIA states the principles and expectations governing the behaviour of individuals and organisations in the conduct of internal auditing. It describes the minimum requirements for conduct and behavioural expectations rather than specific activities.



### 1.1.2 CODE OF ETHICS

The purpose of the Institute's code of ethics is to promote an ethical culture in the profession of internal auditing and is based on the IIA's definition:

*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.*

A code of ethics is necessary and appropriate for the profession of internal auditing founded as it is on the trust placed in its objective assurance about risk management, control and governance. The Institute's code of ethics extends beyond the definition of internal auditing to include two essential components:

- principles that are relevant to the profession and practice of internal auditing
- rules of conduct which describe behavioural norms expected of internal

## auditors

Ethics are inherent in the internal audit process, from operations to risk management to governance. The tone at the top of the internal audit profession is set by the IIA's code of ethics. Established to promote an ethical culture throughout the profession, the code of ethics not only includes relevant principles and rules of conduct for internal auditors, but also presents an enviable benchmark for ethics throughout the organisation.

To comply with the code of ethics, internal auditors must demonstrate honesty, diligence and responsibility, observe the law and make appropriate disclosures. They must not knowingly be a party to any illegal activity, or engage in acts that discredit the profession or the organisation. They must respect and contribute to the legitimate and ethical objectives of the organisation.

In addition, internal auditors must not participate in any activity or relationship that might impair their unbiased assessment or professional judgement or be in conflict with the interests of the organisation, and they must make known all material facts that, if not disclosed, might distort their review. At the same time, they must protect information acquired in the course of their duties and never use it in unethical or illegal ways or for personal gain. Finally, they must demonstrate their competency by their knowledge, skills and experience, continually improve their proficiency, effectiveness and quality, and perform in accordance with the standards for the professional practice of internal auditing.

The contents of the code of ethics are concise and clear and require no further explanation. You should ensure that you have a thorough knowledge of the contents and are able to explain, apply and integrate them.



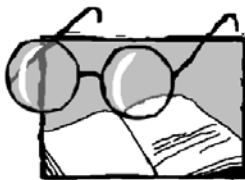
Ask yourself whether you would trust an ex-thief or somebody who has accepted bribes to act as your internal auditor.

Would you trust their internal audit reports?

Would you trust a person who is unscrupulous to investigate the systems in place in your organisation? It would be like taking a thief through your house and showing him or her what they could steal and how your security system operates.



Complying with the code of ethics is what distinguishes an auditor – a professional – from the general public. The code of ethics assumes trustworthiness. It assumes that the auditor is skilled and knowledgeable. When you, as an internal auditor, shed these qualities by failing to comply with the code of ethics, even if it only happens once, you will lose the trust of the people who rely on you to do your job. In future they will have no confidence in your ability to do your job properly.



Study the following:

- International Professional Practice Framework (IPPF) – Code of ethics

Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 2:

- Mandatory guidance
  - The code of ethics



You are an IS auditor applying for a senior auditing position in a large manufacturing company. During the interview the chief audit executive (CAE) asks you the following question: What are the basic principles of the IIA's code of ethics?



In your answer you need to mention the following principles of the code of ethics: integrity, objectivity, confidentiality and competence. You also need to discuss each of these concepts by explaining its meaning. You need to make a detailed study of the code of ethics.



### Notes

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## **STUDY UNIT 1.2: INTERNATIONAL STANDARDS FOR THE PROFESSIONAL PRACTICE OF INTERNAL AUDITING (STANDARDS)**



### **1.2.1 INTRODUCTION**

In this study unit we will revise the framework of internal auditing and the purpose and relevance of the standards.

Standards are principle-focused and provide a framework for performing and promoting internal auditing.

### **1.2.2 THE INTERNATIONAL PROFESSIONAL PRACTICES FRAMEWORK (IPPF)**

The standards embody the best in internal auditing practice and principles worldwide. They provide the basis for measuring internal auditing performance and the potential of internal audit to improve management processes and operations.

#### **The purpose of the standards**

- to delineate basic principles that represent the practice of internal auditing as it should be performed
- to provide a framework for performing and promoting a broad range of value-added internal auditing activities
- to establish the basis for measuring internal auditing performance

- to foster improved organisational processes and operations

### **Adherence to the standards**

- **Mandatory:** Compliance is required and the guidance is developed following due process, which includes public exposure. Compliance with the principles set forth in mandatory guidance is essential for the professional practice of internal auditing.
- **Strongly recommended:** Compliance is strongly recommended and the guidance is endorsed by the IIA through a formal review and approval process. It describes practices to implement the code of ethics and standards effectively.

### **Mandatory**

Definition

International Standards

Code of Ethics

### **Strongly recommended**

Position Papers

Practice Advisories

Practice Guides





The standards consist of the following:

### **Attribute standards**

Attribute standards (the 1000 series) address the characteristics (attributes) of organisations and individuals performing internal audit activities. Attribute standards describe the attributes or characteristics needed for the effective administration of any internal audit activity.

The attribute standards are more relevant to the senior members of the internal audit activity, as they describe some of the internal administrative duties that senior internal auditors normally perform. You will notice when you study the standards that in most cases the attribute standards highlight what the chief audit executive or CAE (the person in charge of the internal auditors) must do. You are not expected to be able to do the manager's job, but if you know and understand the reason behind the overall administration and planning of the internal audit activity, you will be in a better position to understand the value of an individual internal audit assignment that you might be required to perform.

The main attribute standards include the following:

- Purpose, authority and responsibility: The purpose, authority and responsibility of the internal audit activity should be formally defined in a charter, consistent with the standards and approved by the board.
- Independence and objectivity: The internal auditing activity should be independent and internal auditors should be objective in performing their work.
- Proficiency and due professional care: Engagements should be performed with proficiency and due professional care.
- Quality assurance and improvement programme: The CAE should develop and maintain a quality assurance and improvement programme that covers all aspects of the internal audit activity and continuously monitors its effectiveness. The programme should be designed to help the internal auditing activity add value to and improve the organisation's operations and to provide assurance that the internal audit activity conforms with the standards and the code of ethics.

## **Performance standards**

Performance standards (the 2000 series) describe the nature of internal audit activities and provide quality criteria against which the performance of these services can be measured. Performance standards deal with the actual execution (performance) of internal audits, starting with the overall planning of all the audits for the year and then breaking them down into the different steps of the audit process.

This process follows the logical sequence described below:

- The year starts with the compilation of an annual audit plan that shows all the work planned by the internal audit activity for that year.
- This plan indicates the resources needed to perform the audits by considering the number of people needed, the skills and experience they should have and whether or not the required audit equipment is available.
- Finally, the plan describes the processes that must be followed for each audit, and it guides the consulting process for the cases where the internal auditor has been requested to consult.

Although the first stage, managing the internal audit activity, is the duty of the chief audit executive, the rest of the processes involve all the staff in the internal audit activity.

The audit process for individual audits also follows a set format.

The main performance standards include the following:

- Managing the internal audit activity: The CAE should manage the internal audit activity effectively to ensure that it adds value to the organisation.
- Nature of work: The internal audit activity should assess and improve the organisation's risk management, control and governance processes.
- Engagement planning: Internal auditors should develop and record a plan for each engagement.
- Performing the engagement: Internal auditors should identify, analyse, evaluate and record sufficient information to achieve the engagement's

objectives.

- Communicating results: Internal auditors should communicate the engagement results promptly.
- Monitoring progress: The CAE should establish and maintain a system to monitor the disposition of results communicated to management.



You should be able to differentiate between the attribute and performance standards.



### **Choose the correct alternative**

An auditor who is nearly finished with an audit discovers that the director of marketing has a gambling habit. The gambling issue is not directly related to the existing audit, and there is pressure to complete the current audit. The auditor notes the problem and passes the information on to the chief audit executive but does no further follow-up. The auditor's actions would...

- 1 be in violation of the IIA Code of Ethics for withholding meaningful information.
- 2 be in violation of the Standards for the Professional Practice of Internal Auditing because the auditor did not properly follow-up on a red flag that might indicate the existence of fraud.
- 3 not be in violation of either the IIA Code of Ethics or Standards for the Professional Practice of Internal Auditing.

4 both 1 and 2.



Correct alternative is **(3)**: There is no violation of either the Code of Ethics or the *Standards*. See options (1) and (2). Option (1) is incorrect. The auditor is not withholding information because he or she has passed the information along to the CAE. The information may be useful in a subsequent audit in the marketing area. Option (2) is incorrect. The auditor has documented a red flag that may be important in a subsequent audit. This does not violate the *Standards*. Option (4) is incorrect. Option (3) is the only correct answer. This refers to the Code of Ethics, namely the objectivity rule of conduct.



Study the following sections in your prescribed textbook:

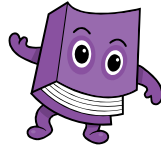
*Internal auditing: assurance & consulting services*, chapter 2:



- The international professional practices framework
- Mandatory guidance
  - The definition
  - The international standards for the Professional Practice of Internal Auditing
  - The attribute standards
  - the performance standards
- How the international professional practices framework is kept current
- Exhibit 2-8: The IPPF Guidance Development Process



Study the following:



- Attribute standards
- Performance standards



### **Choose the correct alternative**

The Standards for the Professional Practice of Internal Auditing require an internal auditor to have the knowledge, skills, and disciplines essential to perform an internal audit. Which of the following correctly describe the level of knowledge or skill required by the Standards? Auditors must have...

- 1 proficiency in applying knowledge of auditing standards and procedures to specific situations without extensive recourse to technical research and assistance.
- 2 proficiency in applying knowledge of accounting and computerised information systems to specific or potential problems.
- 3 an understanding of broad techniques used in supporting and developing audit findings and the ability to research the proper audit procedures to be used in any audit situation.
- 4 a broad appreciation for accounting principles and techniques when auditing the financial records and reports of the organisation.



Correct alternative is **(1)**: Proficiency in the application of the Standards is required. Option (2) is incorrect. An appreciation of, and not proficiency in, accounting and computerised information systems is required. Option (3) is incorrect. Proficiency in, not an understanding, of audit techniques is required. Option (4) is incorrect. Proficiency in, not a broad understanding of, accounting principles is required when auditing financial records.



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## **STUDY UNIT 1.3: OTHER GUIDANCE IMPACTING ON SPECIFIC INTERNAL AUDIT ASSIGNMENTS**



### **1.3.1 INTRODUCTION**

The other category of guidance (development and practice aids) includes a variety of materials that are developed and/or endorsed by the IIA. This category includes research studies, books, seminars, conferences and other products and services related to the professional practice of internal auditing that do not meet the criteria for inclusion in mandatory guidance, but may be very useful for internal auditors in executing their responsibilities.

### **1.3.2 OTHER GUIDANCE**

#### **Practice advisories**

Guidance on the second category (practice advisories) is strongly recommended and endorsed by the IIA but is not mandatory. Practice advisories may help to interpret the standards or to apply them in specific internal audit environments. Although some practice advisories may be applicable to all internal auditors, others may be developed to meet the needs of a specific industry, a specific audit speciality or a specific geographic area. All practice advisories will be submitted to a formal review process by the Institute's Professional Issues Committee or another group designated by the Guidance Planning Committee.





Study the following:

- Practice advisories

You have to study the practice advisories to understand and be able to interpret the standards that are mandatory. You should be able to recall the practice advisories address approach, methodology and considerations, but not detailed processes and procedures. Practice advisories explain and expand how standards can be applied by internal auditors. They are continually being added and changed.



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 2:

- Strongly recommended guidance
- Standards promulgated by other organisations



### Notes

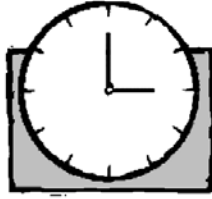
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### **Topic summary**

In this topic we explained the importance of the IPPF with specific reference to the code of ethics with which internal auditors must comply. We also discussed the overall framework for professional internal auditing practice. The framework of competencies for internal auditors represents an important development in the nature of internal auditing.

We established that the practice advisories, position papers and practice guides provide guidance that is helpful to internal auditors in implementing the definition of internal auditing, the code of ethics and standards.

## PART B: SIGNIFICANT FACTORS IMPACTING ON CONDUCTING SPECIFIC AUDIT ASSIGNMENTS

### TOPIC 2: NATURE OF AND LEGISLATURE PERTAINING TO SPECIFIC AUDIT ASSIGNMENTS

#### INTRODUCTION AND PURPOSE OF THE TOPIC

As it developed, different applications of internal auditing came into being. The different forms of internal auditing aim to improve organisational performance, but the distinction lies in the particular aspect of organisational performance on which the audit focuses.



#### LEARNING OUTCOMES

**After you have studied this topic, you should be able to:**

- explain the development of a variety of applications in internal auditing
- demonstrate knowledge of the purpose and nature of the various forms of internal auditing

#### CONTENT OF THE TOPIC

Study unit	Title
2.1	Different types of specific audit assignments
2.2	Resources, skills and technique requirements for special audit assignments.

## **STUDY UNIT 2.1: DIFFERENT TYPES OF SPECIFIC AUDIT ASSIGNMENTS**

### **2.1.1 INTRODUCTION**

In auditing there are different types of audits. In this study unit we give a brief description of the different types of audit in internal auditing and the different types of specific audit assignment.



### **2.1.2 THE DEVELOPMENT OF A VARIETY OF APPLICATIONS IN INTERNAL AUDITING**

The top management of an organisation needs support in the form of internal auditing to ensure that the policy and procedures introduced in an effort to achieve their organisational goals are being complied with. Internal auditors originally performed only financial and compliance audits. Financial and compliance auditing concentrates on compliance with policy and procedures within the financial systems of an organisation to ensure that the assets of the organisation are being properly safeguarded, that the information produced by the financial systems of an organisation is accurate and reliable and that the Acts and regulations applicable to the organisation are being complied with.

The general role and responsibilities of internal auditing has changed, however, along with the development of the discipline, and the support of management and the improvement of organisational performance have gradually become more important. Value for money auditing, performance auditing and operational auditing are some of the terms used the audit form that aims to ensure the economy, efficiency and effectiveness of the operations of an organisation. Because modern internal auditing evaluates all the activities of an organisation and there are so many facets to each organisation, various specialised fields in internal auditing have

developed over time, such as management auditing, environmental auditing and quality auditing. With the development of computer technology, another specialised field in auditing has emerged, namely computer auditing.



### 2.1.3 THE PURPOSE AND NATURE OF VARIOUS FORMS OF INTERNAL AUDITING

Internal audit activities perform different types of audit. Since they all strive to improve organisational performance in some way, there is no fundamental difference in the underlying philosophy of the types of auditing discussed below. The differences lie in what aspect of performance they focus on. Performance auditing and operational auditing address the extent to which a unit meets its performance objectives (effectiveness) and how well it uses resources (efficiency and economy).

#### 2.1.3.1 *Compliance audits*

Compliance can be defined as conformity and adherence to applicable laws and regulations as well as policies, plans, procedures, contracts or other requirements. Laws and regulations are imposed externally and must be complied with. Inadequate information systems may lead to the organisation inadvertently breaching the laws of the country with result of losses in terms of fines and penalties.

Compliance audits are carried out in order to determine whether a business entity has complied with specific policies, plans, procedures, laws, regulations or contracts that affect the organisation. In order to complete a compliance audit successfully, there must be established criteria against which the compliance can be measured.

**Compliance objectives** pertain to the adherence to laws and regulations to which the entity is subject to. They are dependent on external factors, such as environmental regulations and tend to be similar across all entities in some cases and across an industry in others.

**Compliance testing** seeks to establish the degree to which control mechanisms are being applied as prescribed and the results should highlight non-compliance in pursuit of the defined test objective. Often what is meant to happen does not, and procedures that should be in place are ignored.

A company may require several compliance audits to review regulatory adherence in multiple departments such as finance, IT, manufacturing, human resources and in the case of certain types of financial firms, marketing and sales.

**Compliance tests.** Here one is testing the existence or otherwise of a particular control. The test is of a yes/no nature where an attribute is either present or does not exist. An example may be a test to determine the number of purchase invoices that have not been authorised by a designated officer before being paid.

### **Example**

The focus of compliance auditing is on compliance with laws and regulations, statutes and internal policies. A compliance audit therefore sets out to discover how well a unit or organisation complies with an established set of “rules”. Clearly, the level of compliance with formal rules is an aspect of performance. Although it is an important aspect, it is not the only one an auditor is concerned with.

#### *2.1.3.2 Financial audits*

During a financial audit, an internal auditor looks for evidence relating to the reliability and integrity of financial information. When such audits are conducted by an internal auditor, the information is normally intended to be used by management for internal decision-making purposes. The audit may include both operating and financial data. Financial audits normally include both a review of the accuracy and completeness of the numbers themselves and an evaluation of the adequacy and effectiveness of the controls that management have implemented to safeguard assets.

Auditing of financial statements is directed at assessing the accuracy of financial reports relating to financial conditions and operating performance. This type of

auditing is usually associated with an external audit and includes ensuring the fairness of financial reporting.

**Substantive tests.** These tests are carried out to establish the extent to which the implications of a control weakness may be quantified. We may be concerned to discover the total value of purchase invoices incorrectly posted to the wrong year due to poor cut off procedures.



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 1:

- The relationship between auditing and accounting
- Financial reporting assurance services: external versus internal

*Internal auditing: assurance & consulting services*, chapter 10:

- Audit procedures
  - ✓ Manual audit procedures

#### *2.1.3.3 Performance audits*

Performance auditing involves firstly determining management's objectives, then establishing whether the management controls that exist lead to effectiveness, efficiency and economy.

An internal auditor must determine

- which key performance indicators are in use
- whether they are appropriate
- whether control objectives have been achieved

Performance auditing will be discussed in more detail in Topic 3 of this module.

### **Example**

Performance auditing and operational auditing address the extent to which a unit meets its performance objectives (effectiveness) and how well it uses resources (efficiency and economy).

#### *2.3.1.4 Environmental audits*

During a typical environmental audit, a team of qualified inspectors conducts a comprehensive examination of a plant or other facility to determine whether it is complying with environmental laws and regulations. The team systematically verifies compliance with applicable requirements using professional judgement and evaluations of on-site conditions. The team may also evaluate the effectiveness of systems in place to manage compliance and assess the environmental risks associated with the facility's operations.

Effective environmental audit programmes have a number of characteristics in common. They require the strong support of their organisation's management. They also require adequate allocation of resources to hire and train audit personnel. In addition, to be effective, audit programmes must operate with freedom from internal or external pressure and employ quality assurance procedures to ensure the accuracy and thoroughness of audits.



Access the following link and work through the following presentation explaining what environmental auditing entails, the different types of environmental auditing, tools and techniques for completing an environmental audit as well as the practicalities of environmental audits.



[https://www.environment.gov.za/sites/default/files/docs/series14\\_environmental\\_auditing.pdf](https://www.environment.gov.za/sites/default/files/docs/series14_environmental_auditing.pdf)

#### 2.3.1.5 *Fraud audits*

Fraud auditing involves assisting management in creating an environment that encourages the detection and prevention of fraud in commercial transactions. This may involve assisting in setting the standard for the organisation with an appropriate code of conduct and conflict-of-interest policy.

A fraud auditor must know

- the realm of fraud possibilities (How can it happen?)
- the sources of information and evidence (Where do I look?)
- whether the environment is conducive to fraud (Is fraud likely?)
- the areas of fraud opportunity (Where can it happen?)
- the laws of evidence (How can I prove it?)

A fraud auditor must be capable of conducting a review of internal controls, assessing the strengths and weaknesses of those controls, identifying abnormal transactions and distinguishing between errors and fraudulent entries. This may involve following a computerised audit trail.

A fraud auditor's job is to determine whether a fraud, theft or embezzlement has occurred and, if so, whether there is a criminal law dealing with the matter and whether there is an apparent breach of that law, since not all fraud can be prosecuted under criminal law.

An internal auditor must be alert for red flags and indicators, such as personal behaviour pattern changes or substantial departmental growth or decline behind the norms.

Fraud detection may be reactive, where an internal auditor reacts to allegations and complaints, suspicions and management's intuition. Proactive auditing involves ensuring adequate internal controls through periodic audits, intelligence gathering, reviewing or variances or logging of exceptions.

Fraud auditing will be discussed in more detail in Topic 4 of this study unit.

#### *2.1.3.6 Quality audits*

**Quality auditing** may be defined as a systematic and independent examination to determine whether quality-related activities are implemented effectively and comply with the quality systems and/or quality standards. It is an important part of organization's quality management system and is a key element in the International Organisation for Standardisation (ISO) quality system standard, ISO 9001.

As seen by internal auditors, quality audits cannot be directly equated with assuring quality in the normal sense of the word synonymous with excellence. Quality auditing is a technical term for auditing that is focused on systems and processes rather than outcomes. This follows the corporate governance concept that the properly constituted organisation should be based on a system of well-controlled systems and processes.

Quality auditing has become associated with older forms of management of quality such as TQM. As such, quality auditing is associated with quality enhancement strategies rather than the traditional quality control inspections. Quality enhancement focuses on creating a corporate culture centred on quality, as opposed to quality control, which was a reactive process after the event, and involved rejecting sub-standard products and services.

**Quality audits** are typically performed at predefined time intervals and ensure that the institution has clearly defined internal system monitoring procedures linked to effective action. This can help determine if the organization complies with the defined quality system processes and can involve procedural or results-based assessment criteria.

With the upgrade of the ISO9000 series of standards from the 1994 to 2008 series, the focus of the audits has shifted from purely procedural adherence towards measurement of the actual effectiveness of the Quality Management System (QMS) and the results that have been achieved through the implementation of a QMS.

Quality audits can be an integral part of compliance or regulatory requirements.

If quality is viewed in terms of the appropriateness of systems and processes rather than the more traditional achievement of the correct outcomes, auditing moves from the necessity of having to define best practice and desirable outcomes to evaluating the quality of the processes themselves. Defining the key performance indicators has always been a contentious point in negotiating with management for the audit. Reaching agreement on standard systems of practice is normally considerably easier, since little interpretation is required. From this, it follows that a proper organisational structure is comprehensively systemised and documented, and therefore fully auditable.

#### *2.1.3.7 Programme results audits*

Programme results auditing is auditing the accomplishment of established goals and objectives for operations and programmes. In practical terms, this means audits that determine whether the desired results are being achieved, as well as whether management has considered alternatives to achieve the same results at a lower cost.

Conducting such audits involves

- ascertaining whether a specific objective or goal has been clearly defined for a particular function
- ascertaining whether the objective or goal is relevant and consistent with management's intent
- evaluating any variance between the results and their original stated goals and objectives

In addition the cost-effectiveness of a given programme is evaluated, as it is the cost benefit of continuing a programme. Many internal auditors make extensive use of statistical analysis over a period of time, drawing inferences from the results of the statistics. Complaint records may give a good indication of the extent to which given operations of programmes satisfy the needs of the target market. Management themselves may well be able to give advice on the appropriateness of the programmes and the measurement criteria.

#### *2.1.3.8 IT/IS audits*

IT audits come in a variety of forms. Any of the above types of internal audit could involve the use of computers or, for that matter, the audit of computer systems. IS auditing will be discussed in more detail in topic 5 of this module.

#### *2.1.3.9 Application audits*

Application audits such as the auditing of inventory, payrolls, procurement, sales, treasury and other specific business functions have their own specific characteristics and the audit programme will typically involve a certain degree of standard audit tests.

Both internal and external auditors may perform these types of audits. Once again, however, traditional external auditing emphasis is on fairness of financial representation, whereas internal auditing emphasis is on assisting managers and boards of directors or similar governing bodies with optimum governance and the proper discharge of their duties.



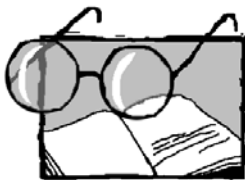
Work through Module 3702 topic 4, methods and techniques for tests of controls.



You are the audit senior in the audit department of a large corporation. The managing director (MD) of the company has asked you to explain the difference between fraud audits and financial audits.



- **Fraud auditing** involves assisting management in creating an environment that encourages the detection and prevention of fraud in commercial transactions. This may involve helping to set the standard for the organisation by establishing an appropriate code of conduct and conflict-of-interest policy.
- During a **financial audit**, an auditor looks for evidence relating to the reliability and integrity of financial information, the information that is normally intended to be used by management for internal decision-making purposes. Financial audits normally include both a review of the accuracy and completeness of the numbers themselves and an evaluation of the adequacy and effectiveness of the controls that management have implemented to safeguard assets.



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 12:

- Types of internal audit engagements and exhibit 12-2 (examples of internal

audit assurance and consulting engagements)



Study the following:

- International Professional Practice Framework (IPPF)

Standards	
1200	Proficiency and due professional care
Practice Advisories	
PA1200-1	Proficiency and due professional care



**Notes**

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## STUDY UNIT 2.2: RESOURCES, SKILLS AND TECHNIQUES REQUIREMENTS FOR SPECIAL AUDIT ASSIGNMENTS



### 2.2.1 INTRODUCTION

Every internal audit is unique in the sense that the environment in which it is carried out differs from one assignment to the next.

### 2.2.2 QUALITIES AND ABILITIES OF AN INTERNAL AUDITOR

An internal auditor should be capable of handling any internal audit situation with confidence and assessing the relevant accountability correctly in the light of the prevailing economic and specific business conditions. Internal auditing standard 1200 states that internal audit engagements must be performed with proficiency.

Internal auditors should therefore have a thorough knowledge of management principles, financial and management accounting and information systems. They should also have experience in a great variety of systems, and complete competence in internal auditing.

A successful internal auditor should possess at least the following qualities and abilities:

- **Curiosity.** The internal auditor should not take anything for granted. By asking questions and discovering the reasons for particular policies and

procedures, the auditor gets to know the audit environment and acquires information that is of value in the operational auditing process.

- **Analytical qualities.** The ability to identify problem areas by rapidly examining a given situation and the ability to identify critical problem areas by distinguishing between material and nonmaterial aspects are important here.
- **Qualities of persuasion.** The success of an internal audit is measured by the extent to which the auditor's recommendations are implemented and implementation is directly proportional to the qualities of persuasion the auditor displays when conveying recommendations to management.
- **Good business judgment.** This quality depends on the knowledge and experience acquired by the auditor and includes the ability to view a problem from a manager's point of view and to ask appropriate questions. Internal auditors should be able to put themselves in the position of management, which may be difficult because the auditor is not likely to have personal experience of an operational management position.
- **Logical thinking.** Analysing an activity, identifying risks and weaknesses and making recommendations that could lead to the improvement of existing systems requires not only knowledge but also logical thinking. Only logical thinking can enable the auditor to make meaningful and practical recommendations.
- **Objectivity.** In the performance of any audit assignment objectivity is a basic requirement. Even if, for instance, the auditor was previously involved in an advisory capacity in the development and implementation of systems within an activity and irrespective of any personal relationships with any of the people working within an activity, the audit assignment should be approached objectively.



- **Communication skills.** The ability to communicate the results of an internal audit effectively is extremely important in ensuring that the shortcomings shown up by an operational audit are understood and effectively addressed by the auditee.
- **Good human relations.** In general employees like to shine in the eyes of their employers. Because there is a possibility that an audit may cast a negative reflection on their work, many people are reluctant to submit their work to an audit. Auditors must remain independent and cannot allow their opinions to be influenced by feelings of sympathy or of dislike or fear. Internal auditors have to undertake audit projects in sections and areas that were never formerly subjected to audit and one of the difficulties is that the auditees are frequently unable to see any purpose in the audit. Furthermore, there is a greater degree of subjectivity involved in operational auditing than in other forms of auditing, which also increases the potential for conflict between the auditors and the staff. Consequently auditors need to understand human relations issues and be able to deal with them effectively if they wish to be successful in operational auditing.
- **Independence.** The internal auditor should be independent of the activity being audited. The auditor should therefore be able to carry out his or her task objectively and without restrictions. Independence is achieved through the auditor's objectivity and the status of the internal audit function within an organisation. This enables the auditor to make impartial and unprejudiced decisions during the conduct of an audit.
- **Self-confidence.** Internal auditors should have sufficient self-confidence to counter the challenges posed by every operational audit. They should also carry out their task and present their opinions with the necessary self-confidence so that management will feel obliged to respond positively.
- **Initiative in developing techniques.** The unique nature of every internal audit requires the internal auditor to display initiative and creativity in the development of audit programmes, performance measurement techniques

and better working methods that will achieve better results.



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 1:

- Competencies needed to excel as an internal auditor
  - Inherent personal qualities
  - Knowledge, skills and credentials



Study the following:

- International Professional Practice Framework (IPPF)

<b>Standards</b>	
1200	Proficiency and due professional care
1210	Proficiency
1210.A1, A2, A3	
1210.C1	
1220-1	Due professional care
1220.A1, A2, A3 and C1	
<b>Practice Advisories</b>	
PA1210-1	Proficiency
PA1210A1-1	Obtaining external service providers to support or complement the internal audit activity
PA1220-1	Due professional care

**Notes**

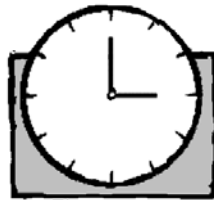
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**Topic summary**

In this topic, we dealt briefly with the origins of various internal audit applications. We noted that internal auditing focuses chiefly on financial, compliance and operational auditing, but the various specialised applications have developed over time. We analysed the relationship between the different internal auditing applications and found that all the audit applications ultimately aim at improving the performance of the organisation.

We also discussed the specific qualities that internal auditors should possess in order to be able to conduct a successful internal audit.

# **PART C: CONDUCTING SPECIFIC AUDIT ASSIGNMENTS**

## **TOPIC 3: PERFORMANCE AUDITING**

### **INTRODUCTION AND PURPOSE OF THE TOPIC**

This topic deals with the nature of performance auditing, its advantages and disadvantages, the Internal Auditing Standards and concepts specifically applicable to performance auditing.



### **LEARNING OUTCOMES**

**After you have studied this topic, you should be able to:**

- analyse the definition of performance auditing and discuss its principal elements and characteristics
- comment on the role of performance auditing in terms of the definition of internal auditing
- evaluate the qualities of an internal auditor involved in performance auditing
- comment on the purpose of performance auditing
- differentiate between the concepts of economy, efficiency and effectiveness of performance auditing and indicate the relationship between them
- advise on the advantages and problems associated with performance auditing
- analyse the specific considerations in the choice of an audit field
- identify the steps taken in the choice of an audit field

## CONTENT OF THE TOPIC

In this topic we define performance auditing and discuss its principal elements and properties.

Study unit	Title
3.1	Discussion of the concept of performance auditing
3.2	The purpose and components of performance auditing
3.3	Specific considerations in the performance of performance auditing
3.4	Identifying the audit field

## STUDY UNIT 3.1: DISCUSSION OF THE CONCEPT OF PERFORMANCE AUDITING



### 3.1.1 INTRODUCTION

In this study unit, we discuss the broad definition of performance auditing and its principal elements. The suitability of performance auditing is explained by analysing its role in terms of the broad definition of internal auditing. The basic qualities and abilities of a performance auditor are also discussed.

### 3.1.2 DEFINITION OF INTERNAL AUDITING AND ACCOUNT OF THE RESPONSIBILITIES OF THE INTERNAL AUDITOR



By now you will have dealt with the definition of internal auditing in the other internal auditing modules and you should already be familiar with it. Because the definition of internal auditing sets out the nature of internal auditing and internal auditing practice, it is obvious that we should begin this module by analysing this definition to determine how performance auditing fits in as part of internal auditing.



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 1:

- Definition of internal auditing
- Helping the organisation accomplish its objectives
- Evaluating and improving the effectiveness of risk management, control and governance processes
- Assurance and consulting activity designed to add value and improve operations
- Independence and objectivity
- A systematic and disciplined approach

The following definition of internal auditing was approved by the International Institute of Internal Auditors in June 1999:

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



The key factors in the above definition will be briefly analysed in the following sections.

### **Internal auditing is an activity**

Internal auditing services may be performed by a function within an organisation or by an external firm, consultant or group of consultants. In the glossary to the internal auditing standards an **internal auditing activity** is described as a department, division, team of consultants or other practitioner that renders a service to an organisation as defined in the definition of internal auditing.

### **An independent and objective activity**

In the definition of internal auditing independence is linked to the positioning of the audit function within an organisation and objectivity to the performance of the audit process. Standard 1100 of the internal auditing standards provides that the internal audit activity should be independent and that the internal auditors should be objective in performing their work.

According to Standard 1110, to be independent, the chief audit executive must report to a level of authority within the organisation that allows the internal audit activity to fulfill its responsibilities. The chief audit executive must confirm to the board, at least annually, the organisational independence of the internal audit activity.

To be objective, according to Standard 1120, individual internal auditors should be impartial and unbiased and should avoid conflicts of interest. According to the glossary to the internal auditing standards, objectivity is an independent mental attitude that requires that internal auditors perform their engagements in such a manner that they have an honest belief in their work product and do not make any quality compromises.

### **An activity that offers assurance and advice**

An internal auditing activity is in the unique position of being able to perform two types of service in order to improve an organisation's operations, namely assurance services and consulting services.

**Assurance services** encompass the traditional auditing services, but recognise that

assurance can be offered at various levels, such as positive assurance which includes compliance auditing, investigation and testing with reporting of results, performance evaluation and limited-scope overviews that offer limited assurance. According to the glossary to the internal auditing standards, assurance activities involve the objective investigation of information with the object of being able to express independent opinions to interested parties regarding risk management, control and management processes within the organisation.

**Consulting services** and improvement of operations may overlap with assurance services, because the knowledge obtained during the performance of assurance services is important in enabling the internal auditor to act in an advisory capacity and improve the operations of the organisation. According to the glossary to the internal auditing standards, consulting activities are much broader in scope than assurance activities, and their object is to support management in achieving their objectives. The nature and scope of consulting activities are agreed with the internal audit client. Some examples are facilitation, process development, training and the provision of advice.



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services, chapter 9:*

- Positioning the internal audit function in the organisation
- Independence and objectivity
- Proficiency and dual professional care

### **An activity designed to add value to an organisation's operations and improve them**

Adding value lies at the heart of business operations today. Organisations demand that each activity should add value and internal auditors cannot ignore this demand. The glossary to the internal auditing standards explain the concept "add value" as follows:

*The internal audit activity adds value to the organisation (and its stakeholders) when it provides objectives and relevant assurance, and contributes to the effectiveness and efficiency of governance, risk management and control processes.*



In the process of gathering data to understand and assess risk, internal auditors develop significant insight into operations and opportunities for improvement that can be extremely beneficial to their organisation. This valuable information can be conveyed in the form of consultation, advice, written communications or through other products, all of which should be properly communicated to the appropriate management or operating personnel.

### **An activity that helps an organisation accomplish its objectives**

By focusing on an organisation and its objectives, rather than on individuals and their responsibilities, the definition emphasises that the primary concern of internal auditing is the success of the organisation as a whole, rather than the success of a specific area or individual. As experts on risk and control, internal auditors should see and market themselves as being in the vanguard of the campaign for ethical corporate governance. They should display due diligence in complementing the efforts of management and the board of directors.

### **An activity that follows a systematic, disciplined approach**

The systematic, disciplined approach is the basis of the internal auditors' unique occupation and their success. "Systematic" may be defined as methodical, or proceeding according to plan. "Disciplined" involves being able to act and work in a controlled manner. This systematic, disciplined approach constitutes the internal audit process.

### **An activity which evaluates and improves the effectiveness of risk management, control processes and management processes**

Effectiveness measures the degree of success in achieving predefined goals. Internal auditing therefore evaluates and improves the extent to which an organisation succeeds in achieving its predefined goals with regard to governance, risk management and control processes.

According to Standard 2110, which deals with governance, 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 activities of and communicating information between the board, external and internal auditors, and management

Governance processes are defined in the glossary to the internal auditing standards as the combination of processes and structures implemented by the board to inform, direct, manage and monitor the activities of the organisation in the achievement of its objectives.

The internal audit activity should monitor and evaluate the effectiveness of an organisation's risk management systems. According to Standard 2120, which deals with risk management, the internal audit activity must evaluate the effectiveness and contribute to the improvement of risk management processes.

According to Standard 2120.A1, the internal audit activity must evaluate risk exposures relating to the organisation's governance, operations and information systems in respect of the following:

- the reliability and integrity of financial and operational information
- the effectiveness and efficiency of operations and programmes
- the safeguarding of assets
- compliance with laws, regulations, policies, procedures and contracts

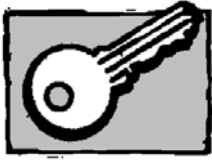
According to Standard 2130, which deals with control, the internal audit activity should assist the organisation in maintaining effective controls and evaluating the effectiveness and efficiency of controls and should encourage the continual improvement of such controls.

Control processes are defined in the glossary to the internal auditing standards as the policies, procedures and activities that are part of a control framework designed to ensure that risks are contained within the risk tolerances established by the risk management process.

On the basis of the results of the risk analysis, the internal audit activity should evaluate the adequacy and effectiveness of control measures relating to the organisation's governance, operations and information systems in respect of the following:

- the reliability and integrity of financial and operational information
- the effectiveness and efficiency of operations and programmes
- the safeguarding of assets
- compliance with laws, regulations, policies, procedures and contracts

Internal auditors should review operations and programmes to ensure consistency with organisational values.



### 3.1.3 DEFINITION OF PERFORMANCE AUDITING AND DISCUSSION OF ITS PRINCIPAL ELEMENTS AND CHARACTERISTICS

This form of auditing is known by various names. Value for money auditing is a term that is used mainly in the public sector to describe the auditing of the economy, efficiency and effectiveness of activities or processes within organisations. For the purposes of this course the following terms may be regarded as synonyms for performance auditing:

- management auditing
- operational auditing
- value for money auditing
- functional auditing

Performance auditing is characterised by the internal auditor's approach, way of thinking and attitude in respect of an audit and not by unique methods. It could be merely an extension of a normal financial or systems audit. In the course of a performance audit the talents, experience and training of individual internal auditors are applied within the operating systems of an organisation.

Performance auditing is referred to in various ways in the literature and it would appear that the term has not yet been finally defined.

Reider, in his book *The complete guide to operational auditing*, defines performance auditing as follows:

Operational (performance) auditing is an audit of operations performed from a management viewpoint to evaluate the economy, efficiency, and effectiveness of any and all operations, limited only by management's desires.

We now examine the principal elements of Reider's definition of performance auditing in greater detail.

- **An audit of operations**

Performance auditing can be carried out in all the functional areas of an organisation, such as marketing, sales, production and human resources. In addition to providing an assurance that the financial information is a true reflection of facts,

performance auditing concentrates on the evaluation of policy, procedures, division of authority, quality of management, effectiveness of methods, special problems and other aspects of an organisation's operations.

- **From a management point of view**

The principal focus of performance auditing is the achievement of management's objectives in the most economic, efficient and effective manner. A general purpose of internal auditing according to the definition of internal auditing is to assist organisations in accomplishing their objectives. This **support** is directed mainly to management, from the highest to the lowest levels.

For this reason it is important that a performance auditor should understand the way of thinking, objectives and concerns of top management in particular and should focus on the aspects that are important to management.

- **Evaluation of economy, efficiency and effectiveness**

Performance auditing is geared to the assessment of the economy, efficiency and effectiveness of the operations of organisations. In an audit of economy and efficiency the auditor looks at the optimum balance between costs and results. Every effort will be made to keep costs to a minimum (economy), but without adversely affecting the achievement of results. At the same time the auditor will attempt to refine the production processes (efficiency), but without incurring excessive costs. In an audit of effectiveness the auditor would determine whether an operation is fulfilling the purpose for which it was established; the emphasis is on results and the achievement of goals.

- **Any and all operating systems within an organisation**

This means that a performance audit can focus on any component of an organisation, whether it is an operating unit, a functional area, a department or an activity within a department, where the audit objective amounts to reviewing the economy, efficiency and effectiveness with which management are achieving their goals.

- **Only the needs of management restrict the scope of operational auditing**

As we mentioned previously, performance auditing should focus on the aspects that are important to management. It is also important that management should realise the significance of performance auditing so that they give performance auditing projects the necessary support and encourage a positive attitude towards

performance auditing within the organisation. To encourage a favorable attitude towards performance auditing it is of the utmost importance that performance audits should be professionally performed and that they should add value to the organisation. The freedom of the internal audit function to evaluate all the activities of an organisation, including planning, policy, procedures and records, should be incorporated in the **internal audit mandate**.



The following are further important characteristics of performance auditing:

- **The purpose of performance auditing**

Performance auditing aims at improving an organisation's **future performance** and it focuses mainly on management's policy, planning, control and decisions. It is the performance auditors' task to determine whether the necessary policy, systems and procedures exist and are being complied with and, if they are, to evaluate the extent to which those policies, systems and procedures contribute to economy, efficiency and effectiveness in the enterprise.

- **Independence**

The potential benefits of performance auditing can only be reaped if the auditors are competent, if they enjoy the support of the executive management and if they are permitted to use their own discretion in all matters. Independence should be guaranteed by the policy of the organisation, reflected in the status of the internal audit function in the organisation and upheld by the professional conduct of the internal auditors. Independence means that internal auditors:

- must not be involved in or be responsible for any operational matters within an activity which is being audited
- must be able to develop auditing programmes without being influenced
- must have full access to all evidence and members of staff wherever this is required for the purposes of the audit
- must be objective in collecting and evaluating information and evidence
- must be able to prepare audit reports on any matters which they consider necessary to report

- **Systematic approach**

A well-planned and systematic approach should be followed in the conduct of any

performance audit. This involves gaining a comprehensive grasp of the auditing environment, developing objectives, determining what information and evidence are available for the attainment of these objectives, collecting and evaluating vouchers, developing findings, reporting to management and following up on the audit report.

- **Criteria for performance appraisal**

Acceptable criteria for evaluating performance are essential for successful performance auditing because it is impossible to evaluate activities without a yardstick of some kind. It is management's responsibility to develop suitable criteria for performance measurement and to apply them in the organisation. In the performance of an audit the performance auditor can use any existing criteria. In the absence of criteria or if the criteria are inadequate, the performance auditor should develop his or her own criteria or borrow them from other sources and then obtain management's approval for their use in the performance audit. Objective criteria for performance appraisal, which both the auditee and the auditor consider appropriate and reasonable are necessary if the audit is to be successful.



Discuss, in terms of Reider's definition of performance auditing, the main elements of a performance audit.



Reider's definition of performance auditing reads as follows: *Operational auditing is an audit of operations performed from a management viewpoint to evaluate the economy, efficiency and effectiveness of any and all operations, limited only by management's desires.*

The elements of this definition are as follows:

- 1. An audit of operations**

Performance auditing can be carried out in all functional areas of an organisation, such as marketing, sales, production and human resources. Performance auditing concentrates on the evaluation of policy, procedures, division of authority, quality of management, effectiveness of methods, special problems and other aspects of an organisation's operations.

## **2. From a management point of view**

The principal focus of performance auditing is the achievement of management's objectives in the most economical, efficient and effective manner. For this reason it is important that a performance auditor should understand the way of thinking, objectives and concerns of top management in particular and focus on the aspects that are important to top management.

## **3. Evaluation of economy, efficiency and effectiveness**

During an audit of economy and efficiency, the auditor looks at the optimum balance between costs and results. In an audit of effectiveness, the auditor determines whether an operation is fulfilling the purpose for which it was established.

## **4. Any and all operating systems within an organisation**

A performance audit can focus on any component of an organisation, whether it is an operating unit, a functional area, a department or an activity within a department, where the audit objective amounts to reviewing the economy, efficiency and effectiveness with which management is achieving its goals.

## **5. Only the needs of management restrict the scope of operational auditing**

As previously mentioned, performance auditing should focus on the aspects that are important to management. The freedom of the internal audit function to evaluate all the activities of an organisation should be incorporated in the internal audit mandate.



You were not required to give the definition of operational auditing and will therefore not receive any marks for it. We have included it as part of our answer to structure the answer. This is a theoretical question and you should ensure that you know your theory well, as these are easy marks in an examination.



### **Notes**

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## STUDY UNIT 3.2: THE PURPOSE AND COMPONENTS OF PERFORMANCE AUDITING



### 3.2.1 INTRODUCTION

If service to management and improved organisational performance can be seen as the foundation of performance auditing, the components of performance auditing that will be discussed in this study unit are the building blocks. In order to perform a performance audit it is necessary to have a thorough knowledge of its components and an understanding of the role each of the components plays in the performance auditing process. In this study unit we begin by dealing with the foundation or purpose of performance auditing before discussing its building blocks or components.

### 3.2.2 THE AIM AND COMPONENTS OF PERFORMANCE AUDITING

The general aims of performance auditing are the following:

- **Performance appraisal**

Performance auditing involves an appraisal of the performance of the organisation/activity that is being investigated. Performance appraisal involves a comparison of the way in which an organisation performs its activities with

- ✓ the goals set by management or by the persons who requested the audit, for example organisational policy, standards, objectives and targets, and
- ✓ other relevant criteria



- **Identification of opportunities to make improvements**

Most improvements fall into the broad categories of improved economy, efficiency and effectiveness. Opportunities for improvement can be identified by means such as conducting interviews with people inside and outside the organisation, by observing operational activities, examining reports and transactions and drawing comparisons with industry standards. Professional judgment and previous experience play a very important role here.

- **Recommendations for the improvement of existing procedures and future action**

The nature and scope of recommendations that arise from performance audit projects vary considerably from one project to the next. In some cases the auditor may be able to make specific recommendations, but in others further research may be required before appropriate improvements and a future course of action can be recommended.

The basis of all three of these aims of performance auditing is to support management in the performance of their duties. There are various reasons why management might request a performance audit. These reasons could be regarded as the specific objectives for a particular performance audit assignment.



### **3.2.3 THE COMPONENTS OF PERFORMANCE AUDITING**

Performance auditing has four principal components, namely:

- financial
- compliance
- economy and efficiency
- effectiveness

#### **3.2.3.1 Financial**

This component is concerned with proper and adequate accounting and reporting procedures. It closely resembles traditional financial auditing, the difference being that in operational auditing it is only one element of an audit assignment and it is made applicable to all the activities of an organisation.

### *3.2.3.2 Compliance*

Compliance is usually dealt with in conjunction with the financial component. It comprises compliance with Acts, regulations and internal policy and procedures. In a performance audit assignment the auditors assess compliance not only with financial legislation, regulations, policy and procedures, but also with all the rules that regulate the operation of an organisation.

### *3.2.3.3 Economy and efficiency*

This component involves the achievement of the optimum balance between costs and results. Costs should be cut to the minimum, but not at the expense of results, and at the same time productivity should be improved, but without incurring excessive costs. In an investigation into economy and efficiency the auditors analyse the way in which the organisation is applying its resources, namely human resources, facilities, equipment, materials and funds. The following aspects are included:

- the purchasing policy of the organisation
- material prices and service costs
- staffing in relation to the functions that have to be performed
- surplus stock on hand
- use of more expensive equipment than necessary
- prevention of losses and wastage of resources
- division of projects into logically manageable tasks
- efficiency and application of operating systems and procedures
- efficiency of documentation flow
- performance of unnecessary tasks or duplication of tasks
- allocation of responsibilities and authority within an organisation
- speed of production and completion time for projects

#### 3.2.3.4 Effectiveness

This component is concerned with the achievement of results and the resultant benefits. In an investigation of effectiveness internal auditors try to establish whether an activity is achieving its purpose and whether the results of an organisation or activity correspond to the targets set, the objectives or any other criterion. An investigation of effectiveness is concerned with quality rather than quantity.

The following procedures would, for example, form part of an investigation into effectiveness:

- evaluating the organisation's approach to the development of realistic targets and objectives and procedures for attaining those targets and objectives
- evaluating the adequacy of management's method of measuring effectiveness
- establishing the extent to which results are being achieved
- identifying the factors that impede satisfactory performance or the achievement of results

The concepts of economy, efficiency and effectiveness, as specific concepts of operational auditing, will now be discussed in greater detail.

#### **3.2.4 ECONOMY, EFFICIENCY AND EFFECTIVENESS AS SPECIFIC CONCEPTS IN OPERATIONAL AUDITING, AND THEIR RELATIONSHIP WHEN ASSESSING ORGANISATIONAL PERFORMANCE**

The components that are unique to performance auditing are economy, efficiency and effectiveness. In your study and application of performance auditing you will be continually confronted with these concepts. A proper understanding of each of these terms, and the relationship between them, is therefore essential.

#### **Organisational performance**

As indicated in the previous study unit, the main purpose of internal auditing is to add value to and improve an organisation's operations. This is achieved primarily by evaluating and improving the effectiveness of the organisation's risk management and control and its management processes. The need to do so has forced internal auditors to develop a sound understanding of the philosophy and practice of management. Internal auditors can add value to the organisation by improving how it performs its activities and the quality of its managers (Barlow et al 1995:41).

Internal auditing can help managers at all levels of an organisation to improve the effectiveness, efficiency and economy of the areas under their control. The definition of internal auditing, however, only mentions the improvement of “effectiveness”. This is because effectiveness has to do with the results of operations, and focusing on improving the results of activities adds more to organisational performance than focusing on improving the efficiency and economy of activities.



This point is illustrated by the following example:

Assume that you, as an internal auditor, are performing an operational audit of the organisation's canteen activity. If you make suggestions that result in the organisation paying less for the food, you will save it money in running the canteen activity. The canteen will be more economical and may save the organisation hundreds of rands every month. If, on the other hand, you make suggestions that result in labour savings or less food wastage, you will have made a greater contribution to the organisation's profitability. The canteen will be more efficient and may save thousands of rands every month. However, if you make suggestions that result in the canteen providing a better quality service which allows it to charge higher prices and/or attract more customers, you will make an even greater contribution. The canteen will be more effective and may make tens of thousands of rands in additional income (Barlow et al 1995:41).

To contribute to organisational performance internal auditors must have a thorough knowledge of the business. If they do not understand the business, they may focus on the wrong areas or fail to provide meaningful recommendations for improving organisational performance (Barlow et al 1995:41).

### **How do economy, efficiency and effectiveness relate to organisational performance?**

What matters most to organisational stakeholders is the organisation's performance or how well it achieves its mission. Performance is an important aspect of an organisation's operation.

An organisation must be focused on achieving its mission and its performance. Performance is all about how well activities are performed. For example, internal auditors should be concerned with how well they audit activities. Say, for instance, an internal auditor audits a section to achieve certain performance objectives. In order to establish how well he/she is performing, the internal auditor can look at how well he/she has achieved those set objectives.

There are three aspects of organisational performance that an internal auditor should be aware of. Commonly referred to as “the 3Es”, these are:

- effectiveness
- efficiency
- economy

All three are measures of how well an activity performs.

**Effectiveness** is the extent to which an activity achieves its stated performance objectives. If you do not perform the activities required to achieve a particular performance objective, you cannot possibly expect to achieve it. Effectiveness amounts to doing the right things. Doing the right things is about performing the right activities to achieve a performance objective. If you perform the right activities, you will achieve the performance objective and be effective. Improving effectiveness, will improve organisational performance.

**Efficiency** is the extent to which a process or activity has been optimised such that, all other things remaining constant,

- its output has been maximised for a given amount of input, or
- its input has been minimised for a given amount of output

An efficient process or activity is one that cannot be further optimised. An inefficient system has some potential for optimisation. Improving the efficiency of a process or activity requires better use of resources to achieve optimal resource usage. This prevents unnecessary waste of all resources and produces concomitant cost savings. Efficiency improvement is a means of reducing costs. If you do not do things right in performing an activity, you will waste resources. You will be inefficient, even if you are effective. It is also possible to do the wrong things, but to do them in the right way, in other words to be ineffective but efficient.

Efficiency considers effectiveness in that it recognises the need to keep other things constant when optimising the input:output ratio. You should maintain the same level of effectiveness (quality) throughout the process. It is pointless to optimise efficiency if the level of effectiveness or quality is reduced during the process.

**Economy** is the extent to which an organisation, unit or activity gets the right quantity and quality of a resource at the right time and best possible price. Obtaining resources at the best price should never be done at the expense of the results obtained. Since economy is concerned with optimising the cost of inputs, it can be considered part of efficiency.

## **The relationship between the 3Es**

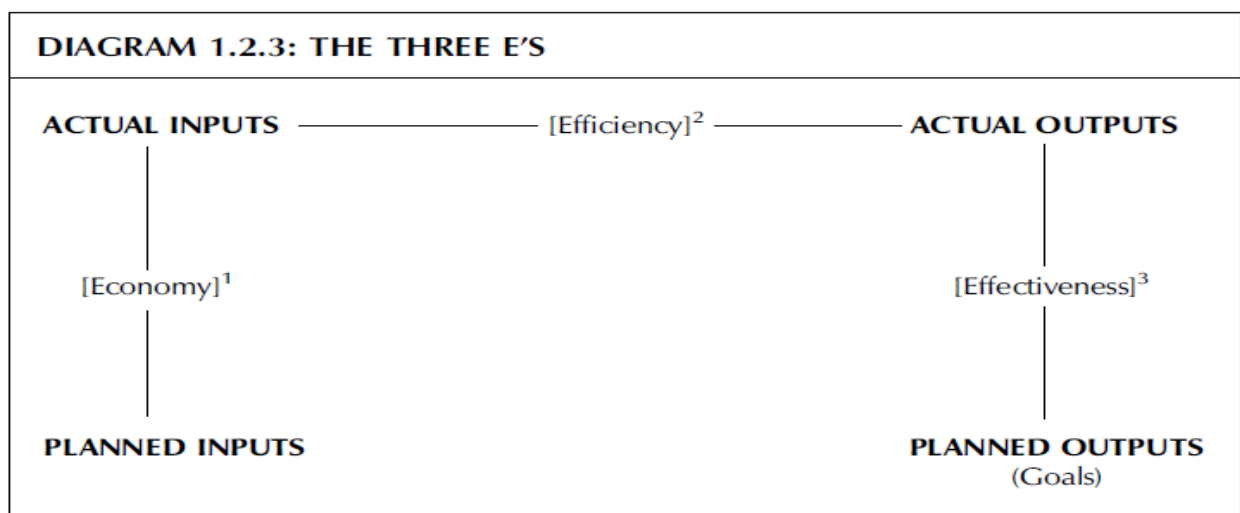
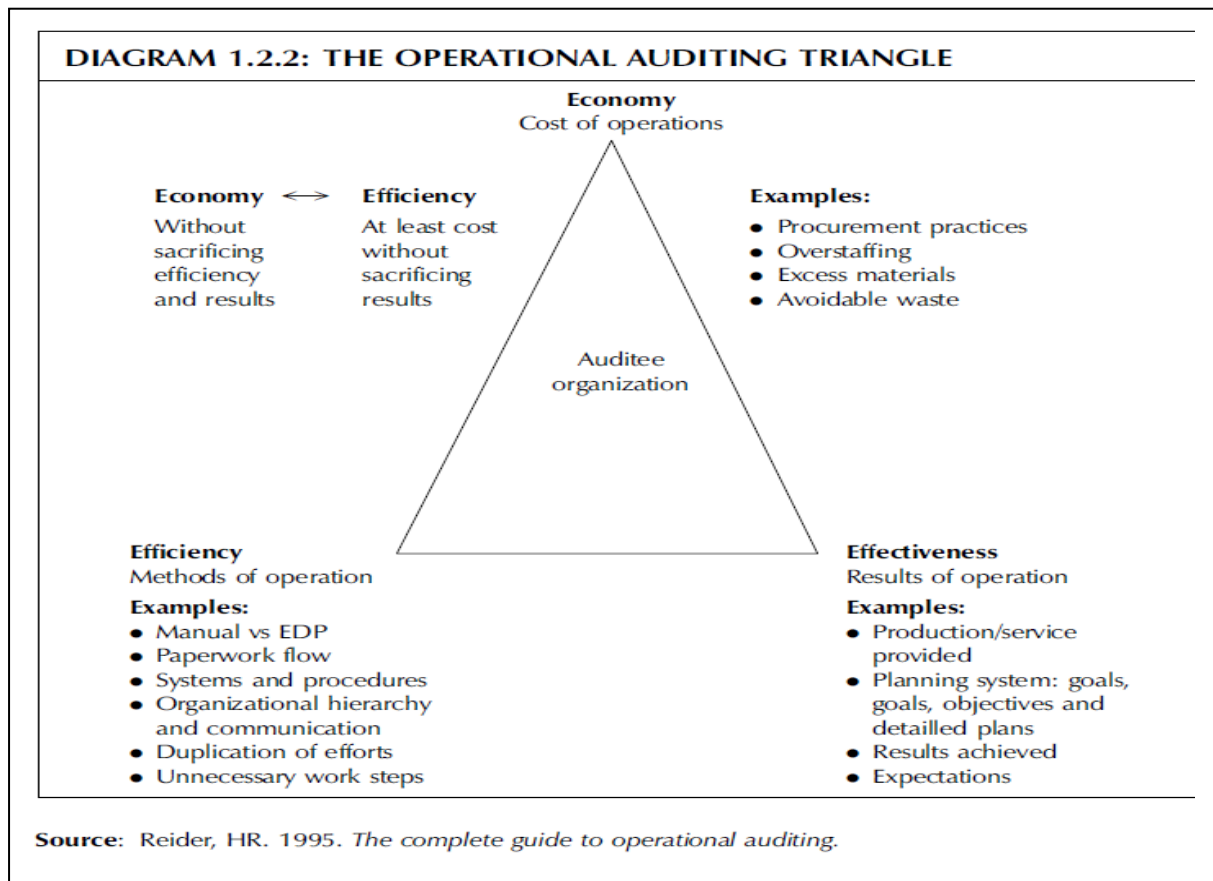
Organisations can set performance objectives addressing the need for efficiency and economy in their activities. The concept of effectiveness therefore encompasses both these performance parameters. Since organisational performance encompasses effectiveness, it also encompasses efficiency and economy.

Cost-effectiveness combines the concepts of effectiveness and cost. It shows the cost of achieving a certain level of effectiveness. The total cost of an activity is the sum of the costs of all inputs (organisational resources used). The purpose of activity-based costing (ABC) systems is to generate this information for many activities in the organisation and make it available to managers to analyse the cost-effectiveness of their activities. A cost-effective activity performs to the required standards at the lowest possible cost. Since total cost is affected by an activity's level of resource usage, a cost-effective activity will often be an efficient one. The concepts of cost and efficiency are different. Efficiency considers an activity's input and output. Cost deals with the input side. You can reduce the cost of an activity without improving its efficiency.

Cost-effectiveness is an important concept because improvements in effectiveness usually require the use of more resources, which cost money. There is a trade-off between improving effectiveness and cost. Raising the performance standards relating to the quality of an activity's output will invariably increase the activity's cost.

Changes in efficiency can also affect effectiveness. It is possible to maximise efficiency at the expense of effectiveness and output quality in particular. Experience has shown that cost-cutting programmes have often led to reduced levels of effectiveness, which in turn have caused customers to switch to competitors. The resulting loss of profits has often far outweighed the "savings" achieved through reduced costs.

The following two diagrams illustrate the interrelationship between economy, efficiency and effectiveness:



**Source:** Chambers, A & Rand, G. 1997. *The operational auditing handbook*.

- (1) *Economy* – the relationship between planned inputs and actual inputs in terms of unit costs
- (2) *Efficiency* – the relationship between actual inputs and actual outputs
- (3) *Effectiveness* – the relationship between actual outputs and planned outputs



You are an audit manager employed by DWARF Limited, a manufacturer of optical equipment for weaponry and aircraft. The chief internal auditor of DWARF Limited requests you to perform a preliminary review of the company's mechanical plant for the purpose of conducting an operational audit.

You are required to formulate **five (5)** audit objectives for assessing the *economic* and *efficient* functioning of DWARF Limited's mechanical plant.



**Audit objectives for assessing the economic and efficient functioning of DWARF's mechanical plant**

1. to determine whether the organisation's policy on purchases will ensure the most economical and effective utilisation of resources
2. to determine whether the stock holding is economical without jeopardising the effectiveness of the mechanical plant
3. to determine whether losses and waste in the mechanical plant are minimised
4. to determine whether the activities of the mechanical plant are grouped in logical, feasible processes or tasks
5. to determine whether document flow and provision of management information throughout the mechanical plant are efficient



In this question you had to apply your theoretical knowledge about economy and efficiency and use that knowledge to formulate audit objectives. A general problem is that students formulate audit objectives that do not refer to the economy or efficiency component. For this question write down all the aspects that relate to economy and efficiency and then formulate an audit objective that relates to each of these aspects, taking into account the information provided in the question. For example, efficiency



addresses the efficiency of documentation flow. An audit objective would be as follows:

“To determine (*formulation of audit objective*) whether document flow and the provision of management information (*theoretical knowledge regarding efficiency*) throughout the delivery department of DWARF (*application to question*) are optimised”

**Note:** No marks will be awarded if the audit objectives are not correctly formulated!

### 3.2.5 THE DEVELOPMENT OF PERFORMANCE OBJECTIVES

Although it is management's responsibility to monitor the extent to which an organisation is achieving results within the objectives set, there are not always clear objectives or measurement criteria which internal auditors can use for the purposes of a performance audit. Internal auditors should then, in cooperation with management, determine objectives, develop acceptable criteria for measurement and work out methods for acquiring the information necessary for evaluating the achievement of results. In order to develop meaningful objectives, the internal auditor must have a knowledge of the nature of and requirements for performance objectives.

**A performance objective is a clear statement of what an organisation, unit or activity wants to achieve.**

When we talk about a performance objective, we automatically include its measure and standard. You must be able to measure the performance objective's level of achievement. In addition you must be able to determine if the level of performance achieved, that is actual performance, meets or exceeds required performance as specified by the standard.

#### **The role of performance objectives**

Performance is concerned with how well activities are performed. You cannot evaluate an activity's performance unless you have established clear performance objectives which enable you to measure and evaluate the level of performance objective achievement. Performance objectives are therefore the backbone of organisational performance. Without them, it is impossible to measure and evaluate performance objectively. If you cannot measure performance, then you cannot evaluate actual performance against what is required. If you cannot evaluate performance, then you cannot identify performance problems and take corrective action.

### **For which aspects of performance should performance objectives be set?**

Performance objectives should address the **quality** and **quantity** of the output from an activity, the **time taken** to perform it and the **cost**. You can therefore set performance objectives for the following aspects of any activity:

- quality (how well)
- quantity (how many)
- time (how soon)
- cost (how much)

This amounts to setting performance objectives for the effectiveness, efficiency and economy aspects of activities (Barlow et al 1995:85).

### **For which aspects of the business should performance objectives be set?**

An internal auditor needs to understand that an organisation must achieve its performance objectives to survive and grow.

To assist managers in improving organisational performance, you must consider all performance objectives that make an organisation effective. Simply achieving financial performance objectives does not necessarily make an organisation effective. Furthermore, you must ensure that all aspects of the business that could have a significant impact on organisational performance are covered.

Top managers must set performance objectives for all those aspects that could have a significant impact on the organisation's performance if they were not managed effectively. At the very least, these should include activities involved in

- growing and developing the business
- producing and delivering services and/or products
- managing the relationships with stakeholders
- managing the organisation's resources, for example finance, information, materials, equipment, people or technology

Similarly, unit managers must set performance objectives for all activities that could have a significant impact on the organisation's performance if they were not managed effectively.

Performance objectives can be specified for all activities from the lowest level to the highest level. The highest level activities may include marketing, production, sales, materials, information systems, finance and personnel. They specify what an activity is trying to achieve in terms of quantity, quality, time and cost. For example, a

possible performance objective is to produce the right quantity of the right quality toys at the right time and at the lowest cost. Alternatively, it can be specified as four separate but related performance objectives that address each parameter individually, for example to produce the right quality toys.

### **Measuring the achievement of performance objectives through performance measures**

**A performance measure is a yardstick against which the achievement of a performance objective can be determined.** It is often possible to identify and define several measures for one performance objective, but it is more practical to use only one measure.



Let's look at an example. A wooden toy manufacturer has a performance objective of paying creditors within 30 days of invoice date. A possible performance measure is the number of creditors outstanding 30 days after invoice date. Let's assume that the accounts department manager has been monitoring the performance of the accounts payable clerk and has found two creditors who have not been paid within the 30-day period. Is the clerk's performance good or bad? You do not know. You need some way of determining what constitutes good or bad performance.

### **Identifying good or bad performance through performance standards**

To be able to make a value judgment on whether the level of performance is good or bad, you must have predetermined standards of performance against which to compare and evaluate actual performance.

**A performance standard is the minimum required level of performance.** Performance standards define **required performance**. They are defined in terms of the performance measures and are used for evaluating performance. Without a performance standard, you cannot evaluate performance – you cannot decide whether actual performance is good or bad. It is a benchmark, set on the performance measure, against which you can compare actual performance.

**By comparing actual performance with the required performance (standard), you can decide whether performance is good (above standard), bad (below standard) or acceptable (same as the standard).**

Let's look at an example. Punctuality might be a personal **performance objective** of yours. But what performance standard do you use to evaluate your performance? First, you must identify a suitable **performance measure**. Let's use the number of times that you are more than five minutes late for appointments over a month. Next, you have to set your **performance standard** – the minimum required performance, say not being more than five minutes late for appointments more than five times in a month. If you achieve the performance standard, you can give yourself a pat on the back for being punctual. If you perform better than the performance standard consistently, perhaps you need to make the standard more demanding.

Sometimes a standard is set at the upper end of a performance measure. For example, one of your performance objectives could be to maintain confidentiality of your information. You decide to measure achievement of this objective by monitoring and recording the number of unauthorised accesses to the information over a set period. You set a tough performance standard of no unauthorised access per month. If you achieve the standard, that is zero recorded unauthorised access, your performance would be judged as good. If you clock up one unauthorised access or more, you do not achieve the standard and your performance is judged as unacceptable, unsatisfactory or simply bad.

### **The hierarchy of performance objectives**

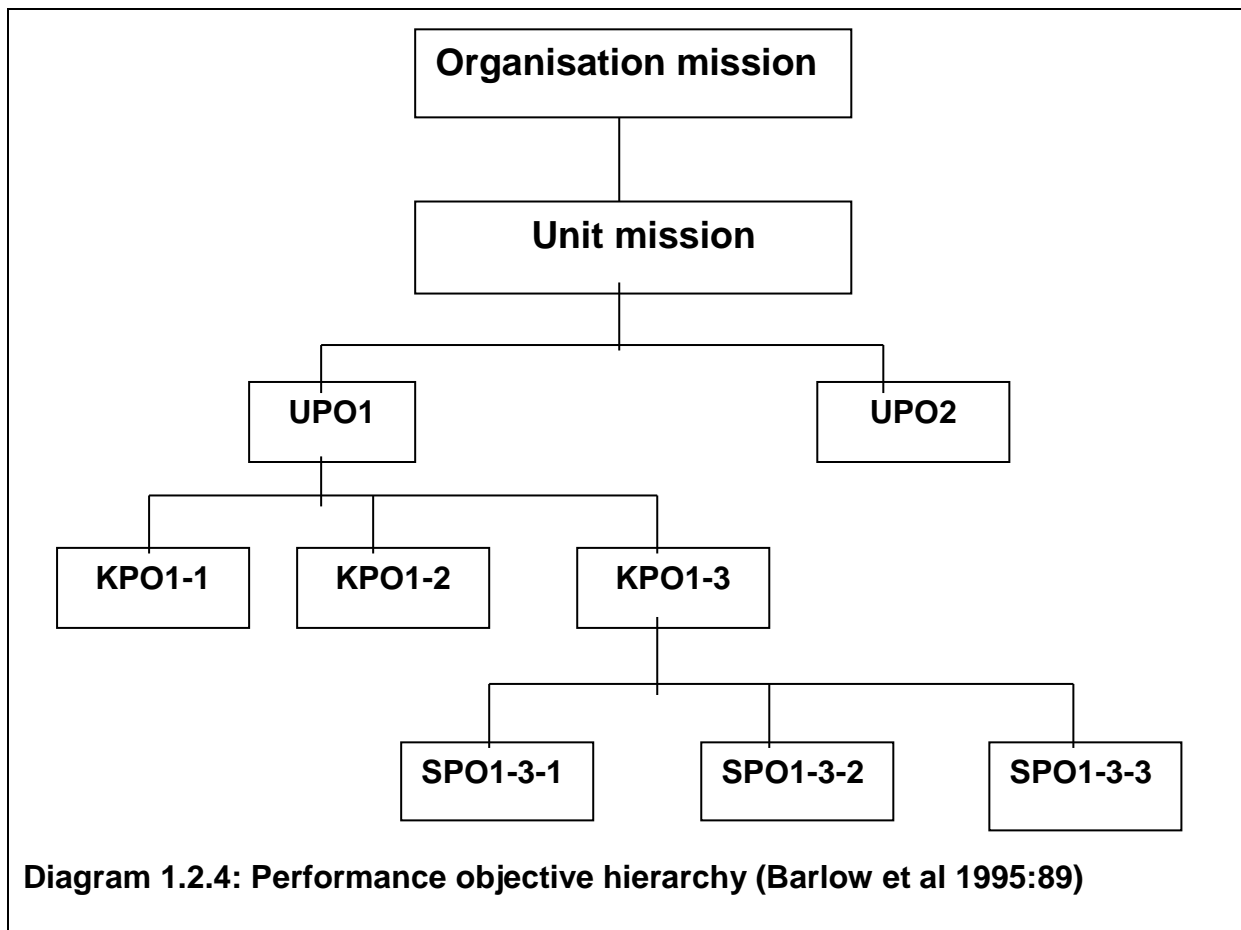
Activities can be broken down progressively into lower-level activities through the process of functional decomposition. Each high-level activity creates a hierarchy of lower-level activities. If performance objectives are established for all activities in the hierarchy, then a corresponding hierarchy of performance objectives is created. It follows that all activities obtained from the analysis of one high-level activity must be performed to complete the high-level activity. Similarly, all performance objectives relating to a family of activities at one level must be achieved to attain the performance objective relating to the parent activity.

To achieve one high-level performance objective, the organisation or unit must achieve all its subordinate performance objectives. Not achieving one lower-level performance objective will have an impact on the achievement of the high-level performance objective. To achieve its mission fully, an organisation or unit must achieve its lowest-level performance objectives.

The decomposition of activities creates a hierarchy of performance objectives. You can define different types of performance objective according to their level in the hierarchy. For example, you could define four types:

- mission – the highest-level performance objective
- unit performance objectives
- key performance objectives

- specific performance objectives



A **unit performance objective** (UPO in diagram 1.2.4) is a clear statement of what a high-level activity within a unit is trying to achieve or what it is marketing or producing. Unit performance objectives must be supportive of and subordinate to the unit's mission.



Let's look at an example. If delivering services is one of the unit's key activities, a unit performance objective could be to deliver services that meet or exceed the service level expectations of all customers in the most efficient manner.

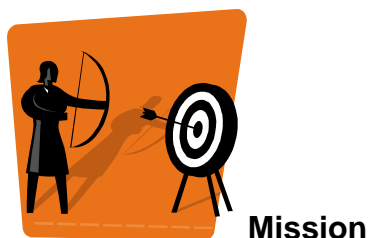
A **key performance objective** (KPO in diagram 1.2.4) is a clear statement of what a sub-activity of a high-level activity is trying to achieve (advertising could be a sub-activity of marketing). A key performance objective contributes to the achievement of its parent unit performance objective. The unit performance objective, in turn,

contributes to the achievement of the mission. Key performance objectives must be supportive of and subordinate to a unit performance objective.

Achieving a family of key performance objectives relating to a unit performance objective will result in the achievement of that unit performance objective.

A **specific performance objective** (SPO in diagram 1.2.4) is a clear statement of what a low-level activity is trying to achieve (eg preparing advertisements is a low-level activity of marketing). A specific performance objective contributes to the achievement of its parent key performance objective. Specific performance objectives must be supportive of and subordinate to a key performance objective.

Achieving a family of specific performance objectives that relate to a key performance objective will result in the achievement of that key performance objective (Barlow et al 1995:88-90).



In the field of organisational performance the mission is the **ultimate performance objective of an organisation or unit**. It conveys the reason for the organisation's or unit's existence and what it is trying to achieve.

The mission should be the starting point of any formal organisational performance management system. The establishment of performance objectives at progressively lower levels in the organisation should be governed by those established above and therefore ultimately by the organisation's mission. The direction and focus provided by the organisation's mission cascade down the organisation. The mission drives organisational performance, since the performance of the entire organisation's units, no matter how they are defined, should be focused on achieving the organisation's mission (Barlow et al 1995:90).

### **The relationship between the mission and performance objectives**

The mission of an organisation or unit is the highest-level performance objective.

Achieving a performance objective can be seen as putting a single piece of a puzzle in its place. To complete the puzzle all the pieces must be put in their right places. To achieve its mission, an organisation or unit must achieve all its performance

objectives. Achieving all but one performance objective will leave the picture incomplete (Barlow et al 1995:91).

### **The mission statement**

**The mission statement is a clearly worded, concise statement of what the organisation is trying to achieve, how it intends to achieve it, and why** (Barlow et al 1995:92).

The mission statement articulates the organisation's vision of the future, a statement of how the organisation's top management see it at some future date (David 1989:89-97)

It has been found that in terms of their market value service and manufacturing companies in the United States have mission statements that often include a pronouncement on one or more of the following components:

- Customers – who are the company's customers?
- Products or services – what are the company's major products or services?
- Location – where does the company compete?
- Technology – what is the company's basic technology?
- Concern for survival – what is the company's commitment to economic objectives?
- Philosophy – what are the company's basic beliefs, values, aspirations and philosophical priorities?
- Self-concept – what are the company's major strengths and competitive advantages?
- Concern for public image – what are the company's public responsibilities and what image is desired?
- Concern for employees - what is the company's attitude towards its employees?

### **Establishing performance objectives**

The starting point for establishing performance objectives for an organisation or unit is its mission. Given the mission, you can identify the highest-level activities that the organisation or unit must perform if it wants to achieve its mission. In units, unit-level performance objectives can be established for these key activities. Then, through functional decomposition, you can break the highest-level activities down into their component sub-activities and thus begin to define the activity hierarchy. You can complete the hierarchy by repeating the process at successive levels. You can use the activity hierarchy to establish a hierarchy of performance objectives which must be internally consistent, in other words performance objectives specified at one level

must define fully the performance objectives at the next level up in the hierarchy. Performance objectives should reflect what an activity's customers want regarding its output. They must be output-oriented.

Good performance objectives are

- measurable (quantitative)
- specific
- results (output) centred
- realistic and attainable
- time-bound

In contrast to this, unsound performance objectives are

- nonmeasurable (quantitative)
- general
- minimum or unattainable
- time-extended

Unit managers are responsible for establishing performance objectives for their activities in collaboration with their immediate manager. They should not set the performance objectives unilaterally. They should agree on them with the manager. Once agreed on, they must be communicated to all unit staff to gain their commitment to achieving them. (Barlow et al 1995:92-94)

Internal auditors need to be prepared to assist managers at all levels in establishing performance objectives. Formally defined performance objectives are relevant to the business, measurable, and supportive of and subordinate to the organisation's mission. As an internal auditor, you must have the skills and knowledge required to set performance objectives. If you do not have the required skills and knowledge or lack the self-confidence required to guide the manager through the task, you should enlist the help of a suitably qualified consultant.

Performance objectives should not be set in concrete. Managers should review them regularly and adjust them if necessary.

### **Assessing the performance objective component**

As part of assessing a unit manager's control system, the internal auditor should assess the quality of the performance objective component. This means assessing the quality of the unit's performance objectives, including its mission, performance measures and standards. If an activity within a unit is being audited, the internal auditor needs to assess both the performance objective component for the activity



and the consistency between the unit's overall mission and the mission of the activity.

To be able to assess the quality of performance objectives, the internal auditor needs standards against which to compare the manager's objectives. These standards must be either "generally accepted standards" within the organisation or agreed on with the manager before the evaluation commences. Performance objectives should

- have three elements – an objective, a measure and a standard
- be clearly stated and unambiguous
- be consistent with higher level performance objectives
- be relevant to the activity
- relate to the quality or quantity of the activity's output, its cost or the time taken to produce it (quality, quantity, time and cost)
- be realistic and achievable within the planning period, usually the financial year
- be documented
- be communicated to all staff that is involved in achieving them

There must be commitment to achieving performance objectives. Unit managers must implement commitment controls that provide assurance that staff will be committed to achieving the unit's performance objectives (Barlow et al 1995:94-95).

### **Assessing missions**

When assessing the mission of the organisation or a unit, the internal auditor must first find out whether the organisation or unit has established its mission and communicated it in some form of mission statement.

An internal auditor needs to ascertain whether the organisation has established its mission. If not, he/she must report this and the potential impact on organisational performance to top management and/or the audit committee. The internal auditor needs to encourage top management to establish and communicate the organisation's mission. The internal auditor needs to assess the following:



First, that the mission statement has been formally defined. Without a mission statement the organisation or unit will be without direction. It will struggle to

- ensure unanimity of purpose within the organisation
- provide a basis, or standard, for allocating organisational resources

- establish a general tone or organisational climate
- serve as a focal point for individuals to identify with the organisation's purpose and direction
- deter those who cannot identify with the organisation's purpose and direction from participating any further in the organisation's activities
- facilitate the translation of objectives into a work structure involving the assignment of tasks to the elements responsible within the organisation
- specify organisational purposes and the translation of these purposes into objectives in such a way that cost, time and performance parameters can be assessed and controlled



Secondly, that the mission statement conveys the organisation's or unit's reason for existence. To assess this, the internal auditor must have a good understanding of the organisation or unit, particularly regarding its purpose. The internal auditor must report any shortcomings to top management and/or the audit committee. Shortcomings usually occur when an organisation or unit does not fully understand the nature of its business and underlying purpose.



For example, many manufacturing organisations fail to appreciate that they are in the service business. They tend to pay more attention to their products than to the services they deliver. They have a product rather than a customer focus. Manufacturers love their products and forget that customers buy them because they meet a need or specific want. Think about the number of products that you have bought that don't satisfy your need - screwdrivers that you can't get a good grip on, pens that mess ink, teapots that pour everywhere but into your cup, and so on.



Thirdly, that the mission has been translated correctly into performance objectives. Even when an organisation or unit has established a good mission statement, it may fail to set performance objectives for those activities that are central to the achievement of its mission. This will not happen if it has a good understanding of what business it is in and the customer needs that it is satisfying.



Fourthly, that managers are keeping their mission statements in line with the changing needs and wants of their customers.



Fifthly, in publicly funded organisations, that the organisation's reason for existence is still valid and that customers still have a genuine need for the service provided. (Barlow et al p.95-96)

**When assessing the quality of the organisation's or a unit's mission, the internal auditor must exercise diplomacy. Managers do not take kindly to being told bluntly that their objective statements are wrong. Point out shortcomings and suggest improvements.**



Describe the meaning of *mission* in the context of organisational performance and explain the relationship between *mission* and *performance objectives*.



**The meaning of *mission* in the context of organisational performance and the relationship between *mission* and *performance objectives***

The mission of the organisation/department/activity is the reason for its existence organisation and gives expression to what the organisation/department/activity wants to achieve.

An organisation's mission can be seen as its primary performance objective. All the performance objectives must be achieved if the organisation wants to achieve its mission.

If a single performance objective is not achieved, the organisation's mission is not fully achieved either. If we compare the organisation's mission to a completed puzzle, then the puzzle pieces are the performance objectives and the puzzle will only be complete if all the pieces are in place.



This question covers the theory of the mission statement and performance objectives of an organisation that is discussed in detail in your study guide. You had to start by explaining what a mission statement is and then link it to performance objectives. Ensure that you study all your theoretical work in detail!



As an internal auditor at an organisation that manufactures stationery, you are currently compiling an audit programme to conduct an operational audit on the plant that manufactures pencils. Your audit objective is to evaluate the economy, efficiency and effectiveness of the plant.

During the preliminary survey, you acquired the following information on the activities of the pencil plant and the purchase and stockkeeping of materials for production purposes:

- a. Purchases of production material are done on behalf of the pencil plant by personnel from the finance section who are responsible for handling purchases for the pencil plant.
- b. Stock levels of production material are monitored by computer. All purchases, requisitions and write-offs are keyed into the computer by the assistant to the storeroom foreman.
- c. Purchases of production material are based on notices printed by the computer and approved by the head of the plant as soon as the stock reaches certain minimum levels.

You are required to formulate **four (4)** audit procedures for each of the three Es, based on the information given in the question, that you would include in your audit

programme in order to evaluate the *economy*, *efficiency* and *effectiveness* of the pencil plant.



### **Economy**

1. Interview senior staff members to determine whether the purchasing department gathers information on prices and suppliers on a frequent basis in order to determine whether materials are purchased at the lowest prices.
2. Examine the procedures followed to determine whether purchasing conditions are agreed upon and followed in such a way that purchases fall within the budget, all possible discounts are obtained and payments are made on terms that are most beneficial to the organisation.
3. Reperform the calculation of minimum inventory levels and most economic purchase quantities to ensure that they are correctly calculated.
4. Confirm the accuracy, reliability and relevance of information used to determine minimum inventory levels and economic purchase quantities.

### **Efficiency**

1. Through observation and discussion determine whether the correct number of people have been assigned to purchasing materials on behalf of the pencil plant to avoid causing unacceptable backlogs or idle time.
2. Evaluate whether it is efficient for the finance department to handle purchases on behalf of the pencil plant.
3. Obtain evidence that all information saved on computer is backed up as necessary, and that the computer system is properly maintained in order to ensure that the information on which order requisitions are based is accurate, and that these notices are processed on a regular basis.
4. Investigate the procedures followed as well as the time from the moment the notice for an order is printed on computer until the order is placed, and ensure that there are no unnecessary delays.

## Effectiveness

1. Ensure that meaningful, realistic and measurable objectives have been set for the pencil plant in respect of, for example, profit margins, output, manufacturing costs and productivity.
2. Evaluate the planning of the plant to ensure that it is directed at achieving these objectives.
3. Examine whether the criteria used to measure the achievement of the overall objectives, for example quality of output, output quantities, spoilage levels, application of materials, direct costs, throughput manufacturing rate, are realistic and meaningful.
4. Evaluate the effectiveness of the pencil plant by measuring the performance of the plant in terms of the formulated objectives and criteria.



In this question you had to apply the theoretical knowledge you have about economy, efficiency and effectiveness and use that knowledge to formulate audit procedures. A general problem is that students formulate audit procedures that do not refer to economy, efficiency or effectiveness. For this question write down all the aspects that relate to economy, efficiency or effectiveness and then formulate an audit procedure that relates to each of those aspects, taking into account the information provided in the question.

For example, effectiveness addresses the achievement of results. An audit procedure would be:

*“To identify (formulation of audit procedure — can also use “to evaluate”, “to inspect” or “to identify”) factors that impeded the achievement of results (theoretical knowledge regarding effectiveness) throughout the manufacturing department of ABC Ltd (application to question)”*

**Note:** No marks will be allocated if the audit procedures are not correctly formulated!



### Notes

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## STUDY UNIT 3.3: SPECIFIC CONSIDERATIONS IN THE PERFORMANCE OF PERFORMANCE AUDITING



### 3.3.1 INTRODUCTION

In this study unit we deal with the internal auditing standards applicable to performance auditing. We also study the benefits of performance auditing and the unique problems associated with it.

### 3.3.2 THE INTERNAL AUDITING STANDARDS APPLICABLE TO PERFORMANCE AUDITING

Performance auditing is a form of internal auditing and the internal auditing standards are as applicable to operational auditing as to any other form of internal auditing. There are, however, a few provisions in the internal auditing standards that require special attention from operational auditors. In this study unit we take a look at the internal auditing standards that justify the performance of performance auditing within organisations and at the requirements laid down by the internal auditing standards for the effective conduct of performance audits.



Read the following chapter, relating to the professional practices framework, in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 2: “The international professional practices framework: authoritative guidance for the internal audit

profession”.

### *3.3.2.1 Justification for performance auditing on the grounds of the internal auditing standards*

According to the definition of internal auditing, internal auditing is an activity which helps an organisation to accomplish its objectives by creating a systematic, disciplined approach to evaluating and improving the effectiveness of governance, risk management and control.

Internal auditing standard 2100 describes the nature of the work of an internal audit activity and expands on the provisions contained in the definition of internal auditing, under the headings of governance, risk management and control.

According to standard 2110, which deals with governance, the internal audit activity must assess, and make appropriate recommendations for, improving the governance processes 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 activities of, and communicating information among, the board, external and internal auditors and management

Standard 2110.A1 provides that the internal audit activity must evaluate the design, implementation and effectiveness of the organisation's ethics-related objectives, programmes and activities.

Standard 2110.A2 provides that the internal audit activity must assess whether the information technology governance of the organisation supports the organisation's strategies and objectives.

Standard 2120 provides that the internal audit activity must evaluate the effectiveness of and contribute to the improvement of risk management processes.

Standard 2120.A1 provides that the internal audit activity should evaluate the organisation's exposure to risk with regard to governance, operations and information systems in the following areas:

- reliability and integrity of financial and operational information



- effectiveness and efficiency of operations and programmes
- safeguarding of assets
- compliance with laws, regulations, policies, procedures and contracts

Standard 2130 provides that the internal audit activity should assist the organisation in maintaining effective control by evaluating the effectiveness and efficiency of control and promoting its continual improvement.

Standard 2130.A1 provides that the internal audit activity should evaluate the adequacy and effectiveness of control in responding to risks within the organisation's governance, operations and information systems regarding the

- reliability and integrity of financial and operational information
- effectiveness and efficiency of operations and programmes
- safeguarding of assets
- compliance with laws, regulations, policies, procedures and contracts

Whereas the aim of financial auditing is to confirm the accuracy and reliability of the information disclosed in financial statements and financial reports, and compliance auditing is more concerned with an organisation's compliance with laws and regulations, performance auditing is specifically concerned with assessing the economy, effectiveness and efficiency of all the operations of an organisation.

The passages from the auditing standards referred to above make it clear that the internal auditing standards make provision for the performance of performance auditing. One could even conclude that internal audit activities that do not include performance auditing but confine themselves to financial and compliance auditing, are not really implementing the internal auditing standards.



Make a detailed study of the standard discussed previously, which you will find in your prescribed textbook *International Professional Practice Framework (IPPF)*.

### 3.3.3 THE ADVANTAGES OF PERFORMANCE AUDITING

Performance auditing is beneficial to the management and employees of an organisation in the following respects:

#### *3.3.3.1 Identification of problem areas, the factors that cause the problems and alternatives that could improve the situation*

This is an important advantage of performance auditing. In many cases management is aware that there is a problem, but is unable to determine its scope or implications. The objective views of the internal auditor, as a third party, often put an organisation's operational problems into the correct perspective. Sometimes all that is required to identify problems is to talk to the staff and then convey their views to management. The employees of an organisation are often more aware of the problems and the reasons for them than management are. The function of internal auditors is to identify the true causes of problems (not the symptoms or possible causes). Their experience and contact with various departments put internal auditors in a position to formulate practical solutions for identified problems and so make a positive contribution to the activities of the organisation. (It is to the advantage of the internal audit department to be able to offer support in the implementation of any recommendations which are made.)

#### *3.3.3.2 Reducing costs by identifying opportunities to reduce wastage and inefficiency*

Every cent saved, without sacrificing efficiency and effectiveness in the process, eventually contributes to the organisation's profit figures. Cost saving is a major component of performance auditing. The internal auditor should, however, be very careful not to introduce short-term cost savings that will cause problems in the long term. It is the task of internal auditors to assist management to operate businesses at the lowest possible cost through proper planning. It is important to cost accurately, and if a decision is taken to cut costs, the decision should be carefully considered to ensure that it does not have negative implications for the organisation at a later stage. This approach to cost reduction differs from simple cost cutting in a way that could interfere with the proper functioning of the organisation.

#### *3.3.3.3 Identifying opportunities to increase income*

Higher income also leads to increased profits, although there is not a rand-to-rand correspondence as in the case of cost savings. The eventual contribution to the profit figure is influenced by the costs incurred to produce the increase in income. Internal auditors should be careful not to make recommendations that could lead to a temporary increase in income but would lead in the long term to additional costs and reduced effectiveness. It should be remembered, however, that the internal auditor

may be able to identify valuable opportunities in the course of an operational audit which, if preceded by proper planning, could contribute to increased income and better profit figures.

#### *3.3.3.4 Identifying undefined goals, objectives, policy and procedures*

Unfortunately not all organisations carry out proper strategic planning and it is frequently found that the organisation's goals, objectives, policy and procedures have not been formally defined. This means that before they can begin a performance audit, internal auditors frequently have to help management to identify undefined goals, objectives, policy and procedures because unless this is done it is impossible to evaluate the effectiveness of an organisation.

#### *3.3.3.5 Identifying criteria for evaluating the achievement of the organisation's objectives and goals*

Even if all the organisation's goals, objectives, policies and procedures have been properly formulated, there are often no criteria for evaluating the extent to which they are being achieved. Internal auditors can help management to develop criteria for assessing effectiveness.

#### *3.3.3.6 Recommendation of improvements to an organisation's policy, procedures and structure*

The internal auditor may well find that the cause of a problem lies in existing policy and procedures. Policy is laid down by management and is related to the basic principles on which the business is run. "The customer comes first" is an example of a statement that conveys the policy of an organisation. Procedures, which are normally also established by management, can be regarded as the methods used to carry out the various functions of the enterprise. When an activity or process is too strictly controlled, the policy and procedures may actually hamper the staff in carrying out their duties and efficiency and effectiveness could be affected. In such a case the policy and procedures may be inappropriate and should be corrected.

The structure of an organisation usually develops over time, as the organisation expands and develops. More personnel are usually appointed as the need arises, with little thought to economy, efficiency and effectiveness when such appointments are made. In an operational audit, which involves an objective examination of an organisation's policy, procedures and structures, the problem areas can be identified and addressed.

#### *3.3.3.7 Evaluating the performance of individuals and sections within an organisation*

A performance audit involves the objective monitoring of the progress made by

sections and individuals towards achieving established objectives. The internal auditors also determine whether the necessary criteria and procedures for measuring performance are in place.

#### *3.3.3.8 Inquiry into compliance with legal requirements and the organisation's policy, objectives and procedures*

Internal auditors have to make certain that an organisation is complying with any laws applicable to it as well as with established policy and procedures, and that the organisation's goals and objectives are being achieved. If the organisation is not complying with some laws, procedures or policies, the possible consequences of such noncompliance should be analysed and pointed out to management.

#### *3.3.3.9 Testing for the existence of unauthorised, fraudulent or otherwise irregular actions*

When conducting any form of internal audit, internal auditors should be on the lookout for the possibility of fraud or other irregularities. In performance auditing, too, where the emphasis is on actions that could have a negative influence on the functioning of an organisation, the internal auditors should keep a vigilant watch for unauthorised, fraudulent or otherwise irregular actions and point these out to management.

#### *3.3.3.10 Evaluation of management information systems and control systems*

Here the internal auditor would pay attention to aspects that include the following:

- Are the management information systems adequate and are they giving management and the appropriate members of staff timely, accurate and reliable information to enable them to run the organisation effectively?
- Are the amount and nature of management information in proportion to the risk attached to the activity and the level of operations within the structure of the organisation? More management information is required as the risk attached to an activity increases, but less detailed information is needed at higher levels of decision making.
- Is there information which is not being supplied and which could influence the successful operation of the organisation?
- Are all the key factors being taken into account in decision making?

#### *3.3.3.11 Identification of possible problem areas in future activities*

Their experience and knowledge of the various activities of an enterprise often make it possible for internal auditors to predict future problems on the basis of past events and point them out to management in good time.

#### *3.3.3.12 Provision of an additional communication channel between people at the operational level and top management*

In many organisations there is a clear distinction between management --- as the decision makers and people in authority --- and the operating staff who have to put the decisions into practice. Because the internal auditors engaged in performance auditing have a good grasp of both the management and the operation of an organisation, they can act as intermediaries between management and operating staff and convey the needs and concerns of one party to the other. Performance auditing involves employees at all levels of the organisation, with the result that management and operating staff are given the opportunity to meet for discussions on all the activities of the organisation.

#### *3.3.3.13 Provision of an independent, objective evaluation of the organisation as a whole*

The management and employees of an organisation are usually so closely involved with the activities of the organisation that they cannot tell in what direction the business as a whole is heading and whether the organisation is being effectively run or not. In the course of a performance audit the internal auditors objectively examine the organisation as a whole and point out both the areas of good performance and the areas that need to be improved.

**Source:** Reider, HR. 1995. *The complete guide to operational auditing*, pp 16-19.

### **3.3.4 PROBLEMS ASSOCIATED WITH PERFORMANCE AUDITING**

#### *3.3.4.1 Performance auditing makes high demands on human relations*

Most people feel uncomfortable when their work is subjected to auditing, especially since they like to look good in management's eyes and they know that any errors that are discovered will be reported. In performance auditing the auditor gets involved in areas that were never previously subjected to audit. Whereas the people who work in the financial sections are used to auditors, the auditor who is conducting an operational audit of one of the nonfinancial activities of an organisation has to do with people whose work has probably never before been subjected to external evaluation and there is more antagonism towards the internal auditor. There is also a higher degree of subjectivity involved in performance auditing than in financial and other forms of auditing and this can lead to conflict between the internal auditor and

the operating staff. In order to ensure the success of performance auditing, the internal auditor should understand the impact of performance auditing on human relations and deal with this correctly.

#### *3.3.4.2 Performance auditing requires special proficiency and skills*

Most trained auditors have been schooled in financial auditing, where the left brain skills of calculation and logic are emphasised. To be successful in performance auditing, internal auditors require equal quantities of left brain and right brain skills. In other words, they should be capable of creative as well as analytical thinking and possess good powers of observation. Internal auditors who engage in performance auditing should have a good grounding in management principles. Performance auditing also requires an in-depth knowledge of the business of the organisation or the activity being audited. Another important requirement is communication and facilitation skills because communication with the staff working on the activity or at the organisation being audited is often the major source of information in an operational audit. There are very few people who possess all the necessary knowledge and skills to carry out a performance audit and it is often necessary to recruit the services of specialists. If an internal audit activity wants to carry out operational auditing, the chief audit executive must ensure that the necessary expertise is developed within the activity or that expertise is acquired by appointing people from different disciplines who are able to complement the skills available in the internal audit activity.

#### *3.3.4.3 High cost of performance auditing*

Performance auditing can only be successfully practised by an audit team that has the necessary knowledge and experience. If the audit team does not have sufficient knowledge in a particular area, the assistance of experts is often required in order to perform the audit. The cost of using an audit team consisting of people with advanced training and experience as well as specialists is naturally high. In addition, management are expected to make bigger inputs as members of the audit control committee, which boosts the cost of the audit even further. Although the savings effected by an operational audit should always exceed the costs attached to the audit, those costs have to be incurred immediately whereas the savings only become apparent over time, as the recommendations that arise from the audit are implemented. The willingness of management to invest in performance auditing projects will depend largely on the proven success of previous performance auditing projects within the organisation.

#### *3.3.4.4 Management involvement in and support for performance auditing*

Performance auditing requires the continuous support of the organisation as a whole, especially that of the executive management. To be able to carry out

performance auditing successfully, the internal auditor requires a mandate to perform performance audits and the service the internal auditor is able to render must be acceptable to management. Management's most important function is to achieve the organisation's mission and goals and if the audit does not make a contribution to this, it will be difficult to get management involved. The development and maintenance of good relations with the personnel and management of an organisation rests with the internal auditors and it is their responsibility to see that they understand the auditing environment, management style and management's expectations surrounding operational auditing.



### Notes

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## STUDY UNIT 3.4: IDENTIFYING THE AUDIT FIELD



### 3.4.1 INTRODUCTION

This study unit deals with the first and one of the major steps in the performance auditing process. We begin by discussing certain considerations that apply when identifying the audit field and then discuss the steps that should be followed in this process.

The most critical question the internal auditor has to answer when carrying out a performance audit is which section, function or activity should be audited. Where is a performance audit most needed and what should the audit focus on?

### 3.4.2 SPECIFIC CONSIDERATIONS IN THE CHOICE OF AN AUDIT FIELD

- *The long-term planning of the internal audit department*

Here we focus on the specific matters that affect the performance auditing process.

Internal auditors usually operate on a limited budget as regards the funds and hours available for performance auditing. Consequently the available time and money must be used in those areas where there is the greatest possibility of improved performance. Because the purpose of the internal audit activity is to support the management of the organisation in discharging their responsibilities, the internal audit projects should focus on the aspects that are important to management in achieving both their own goals and those of the organisation. The bigger the impact of a particular activity on the attainment of the goals of the organisation, the more important the effective functioning of that activity is for management.

The long-term planning of the internal audit activity, which is approved by management and the audit committee, should also make provision for operational audit projects. When the chief audit executive prepares the long-term planning of the internal audit activity, he or she needs to evaluate the risks faced by the particular enterprise and identify the critical conditions within the enterprise.

The following factors could reveal critical conditions for the purposes of performance auditing and indicate possible risk areas:

- ✓ Income, expenses, concentration of fixed assets, sales, production volumes, staff numbers and staff costs for one activity or department that appear to be high in comparison with the figures for the other activities or departments within the organisation.
- ✓ Poor control, for example an inadequate manufacturing control system, poor management reporting or poor planning and control system.
- ✓ Cases of abuse or carelessness. An example would be a production and control system in which transactions go unrecorded or an ineffective personnel evaluation process.
- ✓ Conditions that make it difficult to exercise control, such as inadequate storage facilities, or delays in a shipping process.
- ✓ Activities that are not efficiently or economically carried out, such as ineffective procedures, duplication of tasks, unnecessary work and surplus staff.



- ✓ Trends shown up by analytical analyses, such as major increases or decreases in sales, cost per item, staff numbers, stock levels, et cetera.
- ✓ Areas in which management has identified specific weaknesses or the need for improvement, such as personnel functions, manufacturing procedures, data processing methods and management reporting.
- *Support from management and employees during the performance of the audit*

An important consideration in the choice of the audit field for a performance audit is the willingness of management and the personnel in the chosen audit field to cooperate with the auditors. First, management must display a need for the auditing of a particular activity and be prepared to cooperate in improving that activity and secondly the staff working on that activity must be prepared to cooperate with the internal auditors in carrying out the performance audit and implementing any proposals that may arise from the audit. The cooperation of the staff of the organisation in the performance of a performance audit is of cardinal importance to its success.

- *The budget of the internal audit activity*

Any decision regarding the number of performance audit projects the internal audit activity will undertake and the scope of each performance audit must take account of the size of the internal audit activity's budget. In comparison with financial audit projects, operational audit projects require a greater input in respect of planning, information gathering and research, and this has a direct impact on the costs attached to operational auditing. When they are compared with the potential advantages and savings, however, the costs become less important. Therefore, when deciding how much time and money to spend on an operational audit, a cost-benefit approach should be used.

The following factors should be considered when drawing up a budget for an operational audit:

- The scope of the operational audit. This includes everything that will be subjected to audit.
- The regularity of the operational audit. Is it a one-off audit which requires a major planning input or is it a repeat audit that will require less planning time?
- The nature of the business. An operational audit of a business that is geared to rendering a service, or which concentrates on a single product, usually

takes less time than an operational audit of a manufacturing concern or an organisation that produces a wide variety of products.

- The effectiveness of management. Activities that are not effectively managed usually take more time to audit than activities that are effectively managed.
- The benefits that may be generated by the operational audit. More auditing time should be spent on the areas where the biggest potential benefits from an operational audit lie. The greater the benefits that could be produced, the more time it will usually take to carry out the audit.

### **3.4.3 STEPS IN THE CHOICE OF THE AUDIT FIELD**

#### *3.4.3.1 Identify and describe the problem*

The first step is to identify and describe the problems that should be addressed when carrying out a performance audit. Management usually has the biggest share in identifying problem areas and deciding on the areas to which attention should be given in an operational audit. The internal auditors can, however, assist with the identification of problem areas at the request of management or carry out preliminary investigations or studies (impact studies) on their own initiative in order to identify areas that would benefit from an operational audit.

Impact study questionnaires can be used as an auditing aid to identify critical areas for further investigation. The purpose of these questionnaires is to establish as quickly as possible what functions are carried out, who is responsible for carrying them out and why and how they are carried out. Answers to these questions provide information on matters such as the organisation's goals, activities, operating methods, systems, procedures and authority structures. The internal auditor uses the questionnaire as a guide when deciding on further action and does not rely blindly on the information it contains before it is supported by adequate evidence.

Impact studies can be carried out to determine what influence a particular section has on an organisation, or a particular activity on a section. Impact studies should be carried out as part of the long-term planning of the internal audit activity, but can also be used to identify specific areas for performance auditing.

#### *3.4.3.2 Collecting information and evidence*

The second step is to collect relevant supporting evidence. If an impact study was carried out as part of the first step, the internal auditor will already have a large amount of evidence. The aim of this step is to provide background information in connection with the problem areas identified in the first step and to serve as

evidence of the problem situations that have been identified.

#### *3.4.3.3 Evaluating conditions within the organisation*

This step involves weighing up the prevailing conditions within the organisation. Factors such as the organisational structure, available resources, peak times and down times which might affect the conduct of the audit are taken into account for the purposes of the submission that must be made to management.

#### *3.4.3.4 Obtaining the approval of management for the performance of the performance audit*

When the internal audit activity has gathered sufficient evidence on the areas that have been identified for the purposes of the performance audit and decided to perform a performance audit, top management's approval must be obtained. The planning of a performance audit on the initiative of the internal audit activity should be embodied in the audit planning schedule, which should be submitted to top management annually in terms of the internal auditing standards. Any changes in such planning should be resubmitted to management for approval.

The result of this stage of a performance audit is a list of potential performance auditing areas.



#### **Notes**

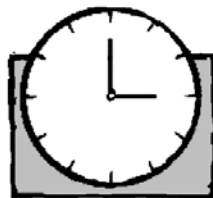
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In this topic, we dealt with the nature and properties of performance auditing and we looked at the possible contribution performance auditing could make to the internal audit function and the organisation as a whole. We saw that performance auditing is a form of internal audit which concentrates on the achievement of the goals of the organisation in the most economic, efficient and effective manner in order to optimise the performance of organisations.

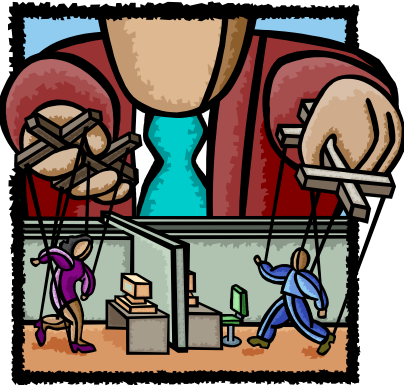
We have studied the main components of performance auditing, namely financial, compliance, economy, efficiency and effectiveness. The concepts of economy, efficiency and effectiveness were studied in greater detail. Because performance objectives are an important element in any investigation of an organisation's effectiveness and the internal auditor frequently has to develop performance objectives in cooperation with management.

We established that performance auditing is justified in terms of the internal auditing standards. We also saw that all the internal auditing standards are applicable to performance auditing, but that it is necessary in performance auditing to pay special attention to particular aspects of the internal auditing standards.

Furthermore, we analysed the advantages of performance auditing and took a look at the problems attached to performance auditing.

We dealt with the considerations and steps associated with the identification of the audit field. We saw that the choice of the audit field is an important step in the performance auditing process and that it largely determines the success of the performance audit. Once this step has been completed and the internal auditors have obtained a mandate to carry out the audit, a formal start is made with the steps in the performance audit process, namely planning, audit programme development, fieldwork, the development of recommendations and reporting. At the request of management the internal auditors can also assist with the implementation of the proposed improvements.

## TOPIC 4: FRAUD AUDITING



### INTRODUCTION AND PURPOSE OF THE TOPIC

The internal auditing standards require internal auditors to exercise due professional care in performing internal audits. This presupposes that internal auditors should be alert to conditions and kinds of activities where irregularities are most likely to occur. To meet this requirement, internal auditors need a basic knowledge of the ways in which fraud is committed in practice, the symptoms of fraud, methods of detecting and preventing fraud and the internal auditor's responsibilities regarding fraud.



### LEARNING OUTCOMES

**After you have studied this topic, you should:**

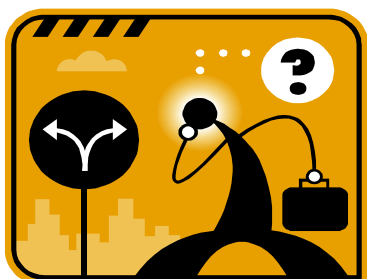
- have a basic knowledge of the ways in which fraud is committed in practice and of the symptoms of fraud
- be able to apply the internal auditing standards relating to fraud investigations
- be able to determine the responsibility of management and the internal auditor in respect of fraud prevention, fraud detection and fraud investigations

## CONTENT OF THE TOPIC

In this topic we define fraud, discuss the basic concepts and elements of fraud and determine the responsibility of the internal auditor and management in respect of fraud prevention, fraud detection and fraud investigations.

Study unit	Title
4.1	Discussion of the basic concepts of fraud
4.2	Fraud risk
4.3	Fraud prevention and detection
4.4	Fraud investigations

### STUDY UNIT 4.1: DISCUSSION OF THE BASIC CONCEPTS OF FRAUD



#### 4.1.1 INTRODUCTION

The cost of employee fraud runs into billions of rand annually in South Africa alone. Although efforts are made on a national scale to combat fraud --- such as the establishment of the Investigating Directorate: Serious Economic Offences which concentrates on fraud investigations --- fraud is expected to continue to increase.

In this study unit we define fraud and explain the elements by which it can be recognised. We introduce various widespread forms of fraud and the main factors that motivate people to commit fraud.



#### 4.1.2 DEFINITION OF FRAUD

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

##### Elements of the crime

The elements of the crime are

(1) **misrepresentation**

(2) which causes or may **cause prejudice**, and which is

(3) **unlawful** and

(4) **intentional**

##### Misrepresentation

The first requirement for fraud is that there must be a misrepresentation. This is the conduct requirement of the crime. Misrepresentation means **a deception by means of a falsehood**. X must, in other words, represent to Y that a fact or set of facts exists which in truth does not exist.

##### Prejudice

We now come to the second element of the crime, namely the requirement that the misrepresentation must **cause actual prejudice or be potentially prejudicial**. Mere lying is not punishable as fraud. The crime is committed only if the lie brings about some sort of harm to another. For the purposes of this crime the harm is referred to as prejudice.

In many instances of fraud the person to whom the false representation is made is in fact prejudiced. For example, X falsely represents to Y that the painting she is selling to Y is an original painting by a famous painter and therefore worth a great amount of money, whereas it is in fact merely a copy of the original and worth very little (if any) money. Actual prejudice is, however, not required; mere potential prejudice is sufficient to warrant a conviction. The prejudice is also not required to be of a patrimonial nature. Let us examine these last two propositions (which incorporate important principles) in more detail.

Prejudice may be either actual or potential. What does "potential prejudice" mean? Potential prejudice means that the misrepresentation, looked at objectively, involved some **risk** of prejudice, or that it was **likely** to prejudice.

### **Intent**

According to the general principles relating to intent, X's intent must relate to all the requirements of the crime other than the intent requirement. This means that, apart from the intention relating to unlawfulness (ie awareness of unlawfulness), X's intent must meet the following requirement: The intent relating to the requirement of **misrepresentation** means that X must know, or at least foresee the possibility, that the representation she is making to Y is untrue.

### **Attempt**

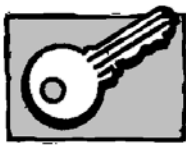
As potential prejudice is sufficient to constitute fraud, the view has long been held that there can be no such crime as attempted fraud, since even if the misrepresentation is not believed, or even if Y does not act on the strength of the representation, potential prejudice is present and consequently fraud is committed. However, attempted fraud is indeed possible. It arises in the case where the misrepresentation has been made, but has not yet come to Y's attention, for example where a letter containing a misrepresentation is lost in the post or intercepted.





Study the following:

- International Professional Practice Framework (IPPF), Attribute Standard 1210-A2.



#### **4.1.3 NATURE AND ELEMENTS OF FRAUD**

##### **Nature of fraud**

Fraud, briefly stated, is a false representation or concealment of a material fact to induce someone to part with something of value. The Institute of Internal Auditors has referred to fraud as encompassing an array of irregularities and illegal acts characterised by intentional deception. It can be perpetrated for the benefit or to the detriment of the organisation and by people outside as well as inside the organisation.

Because of the enormous sums involved and the potentially disastrous effects of fraud and associated wrongdoing, internal auditors are expected to put such unsavoury activities under the spotlight of their audit surveillance.

##### **Elements of fraud**

Fraud can take many forms. It may result from an intentional misrepresentation – the suggestion that something is true, when it is not, by someone who knows it is not. It may be a negligent misrepresentation - the assertion as fact of something which is not true by one who has no reasonable grounds for believing it to be true. It

includes concealment, that is the suppression of a fact by one who is bound to disclose it. It also includes false promises or promises made with no intention to fulfil them.

The elements of legal fraud, or deceit as it was called in common law, are:

- A false representation of a material fact, or in some cases an opinion,
- made with the knowledge of its falsity or without sufficient knowledge on the subject to warrant a representation,
- a person acting upon the representation,
- to his or her damage.



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 8:

- Overview of fraud in today's business world.
- Definitions of fraud



The internal auditors of a bank suspect that one of the bank officials has given loans to fictitious businesses, then transferred the loan amounts to her own bank account and never paid the instalments, as a result of which the bank has suffered material

losses. The bank official's colleagues believe that her luxury house and vehicles, irrespective of her average income, can be attributed to her working wisely with her money by investing it carefully. They are not surprised that she is in a management position at a relatively young age because she gets on well with everybody in the bank, does favours for management, works more overtime than any other official and never takes any leave. The internal auditors were therefore surprised at first by the bank official's nervous appearance and her unwillingness to answer their questions.

## REQUIRED

1. Name and briefly discuss the elements of fraud that are present in the bank official's behaviour.
2. Identify the warning signs in the case study that strengthen the suspicion that the bank official has probably committed fraud.



### 1. Elements of fraud present in the bank official's behaviour

- **Unlawful and intentional** The actions of the bank official were intentional. Approving loans to fictitious companies and then appropriating the funds for own use was intentional, because she was aware that her actions were unlawful and that the bank would incur a loss as a result.
- **Misrepresentation** The bank official made a purposeful misrepresentation to the bank by creating the impression that the bank was lending money to companies, while she misappropriated the funds for herself.
- **Prejudice** The actions of the bank official caused actual prejudice for the bank as the loan instalments were not paid and the bank was not able to

recover the money.

## 2. Warning signals reinforcing the suspicion that the bank official probably committed fraud

- The bank official owns a luxury house and motor cars but she earns an average income.
- She gets on well with everybody in the bank, and does favours for management.
- She works more overtime than any other official at the bank.
- She never takes any leave.
- The bank official appears to be nervous during the audit and is unwilling to answer questions, even though she seems to get on well with everybody.



### 4.1.4 CATEGORIES, FORMS AND EXAMPLES OF FRAUD

To ensure that you will recognise fraud in practice, it is important that you should be familiar with the different ways in which fraud can be committed.

Fraud can be perpetrated by people inside or outside the organisation in order to **benefit** the organisation. Fraud can also be perpetrated by people inside or outside the organisation to the **detriment** of the organisation.

Specific forms of fraud are identified both in the literature and in practice. The most common forms are:

- misappropriation
- embezzlement
- white collar fraud
- external fraud
- computer fraud
- management fraud

**Misappropriation** takes place when a person to whom the responsibility for certain assets belonging to another party has been entrusted uses such assets or allows them to be used in any way that conflicts with the interests or instructions of the owner of the assets, usually with malicious or deceptive intent.

The following are examples of misappropriation by employees:

- the improper appropriation of money, whether generated by cash sales, collected from debtors or generated by the unauthorised sale of assets
- the irregular appropriation of cash received from the sale of assets of which proper record was not kept, for example portable tools, spares, obsolete or unusable inventory or assets that had been written off
- the theft of goods, stationery, assets etc that belong to the organisation
- the irregular transfer of goods or money to a fictitious third party

Misappropriation becomes **embezzlement** when any attempt is made to conceal the act of misappropriation, for example by offering false explanations or falsifying documents. Both misappropriation and embezzlement can be committed against individuals or organisations.

The following are examples of embezzlement, that is attempts to conceal the act of misappropriation:

- altering documents, records or vouchers
- creating false invoices or credit notes
- creating fictitious supplier accounts
- creating false purchase invoices or destroying suppliers' credit notes

- purchasing items for private use on the organisation's accounts and the irregular use of the organisation's credit cards for personal purchases
- submitting false claims for remuneration for expenses
- creating fictitious employees on the organisation's payroll
- approving unauthorised deliveries
- special favours or concessions to clients or other parties in exchange for remuneration in the form of cash or benefits
- use of the organisation's contacts to run a business that is in competition with the employer

**White collar crime** is a term for fraud committed by a respected person or a person who enjoys high social status in the exercise of his or her profession. White collar fraud largely coincides with other forms of fraud discussed in this study unit. The following are some examples:

- crimes committed by people on an individual or ad hoc basis, such as buying goods on credit with the full knowledge that they do not have the means to pay for them
- crimes committed by virtue of a person's position in an organisation or a government or other body which is in conflict with his or her duties or loyalty towards his or her employer, possibly in the form of bribery, embezzlement or misuse of confidential information to which he or she has access
- crimes designed to benefit the organisation, such as the publication of false information in financial reports, the overvaluation of security rendered to secure a loan or the placement of misleading advertisements

- the conduct of a business which is of a criminal nature, such as misleading or deceptive insurance schemes or property transactions

**External fraud** takes place when people outside the organisation perpetrate fraud against the organisation. To be able to perpetrate fraud against an organisation, these people (suppliers, customers and their staff) must have a basic knowledge of the organisation's controls and procedures and must know how to gain access to the organisation's assets in the ordinary course of business. External fraud can also be committed by the organisation's own staff against other organisations with which the organisation has business relations. Collusion between staff from various organisations to derive advantage from transactions between the organisations is also possible.

The following are examples of external fraud:

- short deliveries at a point where the control of the quantities delivered is inadequate
- false claims against suppliers for shortfalls on deliveries and poor quality products
- false statements regarding work done on construction sites, or repair and service contracts where there is inadequate control over these contracts
- the purchase of goods on credit in the knowledge that it will not be possible to pay the account or the tendering of a stolen credit card or a falsified cheque
- the misuse of confidential information of an organisation by people in a position of trust, for example through the misuse of computer access controls or the disclosure or sale of sensitive marketing information to a competitor of the organisation

The form of fraud in which computer programmes and computer-stored data are manipulated to abuse funds and other resources is known as **computer fraud**.

Computer fraud is perpetrated by people with a thorough knowledge of computers and computer applications. Computer fraud can take numerous forms and is increasing all the time.

The following are only a few basic examples of computer fraud:

- unauthorised alteration of master files
- manipulation of computer input
- manipulation or destruction of computer output
- unauthorised modification of an application programme or a transaction procedure
- unauthorised modification of computer operating systems or hardware

The best protection against computer fraud is prevention.

**Management fraud** is the deliberate manipulation of financial and other reports in order to mislead the users of the reports regarding the performance of management. Management fraud can be perpetrated for personal gain, in order to obtain bigger bonuses or promotions, or for the benefit of the organisation, for example to evade taxation or make the organisation's financial performance look better. Management fraud is serious and is very difficult to detect because it is committed by a person who has the power to manipulate records and destroy evidence.

The following are examples of management fraud:

- the withholding or destruction of documents that contain information on activities which differs from other reports on such activities
- the falsification of documents or other evidence in order to support fictitious



records or reports

- collusion with third parties to create false records and evidence in order to support fictitious records and reports
- overreporting of profits and profitability, for example by failing to record certain purchase invoices so that expenditure appears lower, by taking fictitious credit notes into account when calculating the purchasing figures, by deliberately overvaluing inventory, or by underreporting provision for uncollectible debt or losses
- manipulation of accounting cutoff procedures in order to prevent the matching of income and expenditure, for example where credit notes for the current year are taken into account, but the purchase invoice to which the credit note refers is shown under the following financial year
- the issue of falsified financial statements with the object of misleading shareholders

**Note:** Although we have distinguished between various forms of fraud in this section, any use of the word "fraud" in the rest of this study guide should be taken to refer to fraud in all the possible forms in which it can occur in practice.



#### **4.1.5 FACTORS AND REASONS THAT PROMPT PEOPLE TO PERPETRATE FRAUD**

Generally speaking, people are prompted to perpetrate fraud by a combination of three factors.

First, there is pressure on the individual, either internal pressure in the form of debt or a desire for riches, or external pressure in the form of pressure exerted by the

organisation on management to achieve projected profit figures and budgets.

Second, uncontrolled access to organisational assets tempts employees to appropriate them for their own profit.

Third, there are personality disorders. Most people generally prefer to be honest, but unfortunately there are the exceptions who prefer to be dishonest.



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 8:

- The fraud triangle
- Understanding fraudsters



### **Incident 1**

During the review of casual wages in a small and remote branch, it was found that small amounts of money were being paid from the casual wages float. The fact that the amount was too small to be a casual wage led to the investigation. When the person responsible for paying the casual wages was questioned, she broke down in tears and admitted to stealing the amount to pay for her car wash every week. Upon further investigation it became clear that there is no authorisation of the casual wages paid as the amounts are insignificant.

## **Incident 2**

The following incident was reported anonymously via the fraud hotline. All brochures are printed on a regular basis by a specific printing company that was appointed due to its knowledge of the tourism industry, reasonable pricing and the good quality of the brochures supplied by it. Brochures are printed on a quarterly basis to ensure that all the specials for the different seasons are taken into account. During the investigation it became clear that the printing jobs were recently done by a newly formed company. Through further investigation it became clear that the owner of the company was the brother of the procurement officer responsible for ordering the brochures. It became clear that over the past few months, the brochures were not printed at the best price or quality and that the price paid was higher than the average market price. This was evidenced by the doubling of printing costs over the past financial year; it was also noted that a part of the printing costs were classified as advertising costs. In addition, it was discovered that the procurement officer received 25% in cash back, from his brother, for all brochures ordered from the company. Once the brochures ordered were compared with the brochures delivered it became evident that all the brochures ordered were not delivered.

## **Incident 3**

This incident relates to the cancelled bookings process currently being followed by all the branches. During a review of the refunds made to individuals it became clear that a significant amount of money was refunded to a specific individual, on a regular basis. Through the investigation it became clear that the person is employed by a large organisation and her sole responsibility at the company is to book the flights and hotels for the executive team of that company. Due to her frequent dealings with Easy Travel's personnel she became good friends with some of the employees at a specific branch.

Comment on whether or not the incidents investigated constitute fraud, as defined by South African law.

- Incident 1
- Incident 2
- Incident 3



### **Incident 1**

This incident is clearly fraud. The fact that the amount is small is not important as an amount was unlawfully and intentionally misrepresented as casual wages.

### **Incident 2**

This incident is clearly fraud. The procurement officer received a 25 % kickback for all orders placed with the company. This incident is unlawful and intentionally done by the procurement officer. The additional costs are misrepresented as advertising costs.

### **Incident 3**

This incident is an indication of possible fraud that might have been committed. The information is not sufficient to decide whether or not fraud was committed. Additional evidence will have to be collected in order to prove or disprove that there was an unlawful act, an intention to defraud and misrepresentation.



### **Notes**

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## STUDY UNIT 4.2: FRAUD RISK

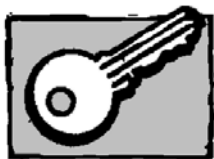


### 4.2.1 INTRODUCTION

All organisations are exposed to fraud risk in any process where human involvement is required. An organisation's exposure to fraud is a function of the fraud risks inherent in the business, the extent to which effective internal controls are present and the integrity of those involved in the process.

Fraud risk is the probability that fraud will occur and the potential consequences for the organisation when it occurs. The probability of a fraudulent activity is based, typically, on how easy it is to commit fraud, the motivational factors leading to fraud and the organisation's fraud history.

In this study unit we look at managing the fraud risk and the fraud risk assessment and explain the key principles for managing fraud risk.



### 4.2.2 KEY PRINCIPLES FOR MANAGING FRAUD RISK

There are five key principles that the organisation can follow to proactively establish an environment that will help it effectively manage its fraud risk. In short these principles are:

1. A fraud risk management programme should be in place

2. Fraud risk exposures should be addressed periodically by the organisation.
3. Prevention techniques should be established.
4. Detection techniques should be established.
5. A reporting process should be in place to ensure potential fraud is addressed appropriately.



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 8:

- Key principles for managing fraud risk
  - Fraud risk governance (principle 1)
  - Fraud risk assessment (principle 2)
  - Fraud prevention and detection (principle 3 and 4)
  - Fraud reporting, investigation and resolution (principle 5)

Study all five principles in detail.



#### **4.2.3 GOVERNANCE OVER THE FRAUD RISK MANAGEMENT PROGRAMME AND FRAUD RISK ASSESSMENT**

Governance over fraud risk management emphasises the importance of a corporate culture that includes the board obtaining assurance about the ethical conduct of management and employees.

The roles and responsibilities in a fraud risk management programme must be formal and communicated. The tone at the top refers to the entity-side attitude of integrity and control consciousness, as exhibited by the most senior executives of an organisation.



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 8:

- Governance over the fraud risk management program
  - Roles and responsibilities
  - Components of a fraud risk management program

All organisations are exposed to fraud risk in any process where human involvement is required. A fraud risk assessment is often a critical component of an organisation's larger enterprise risk management programme. The fraud risk assessment is a tool that assists management and internal auditors in systematically identifying where and how fraud may occur and who may be in a position to commit fraud.



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 8:

- Fraud risk assessment
  - Fraud risk identification
  - Assessment of impact and likelihood of fraud risks
  - Response to fraud risk



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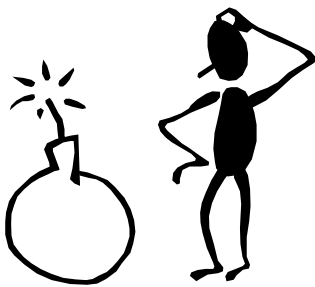
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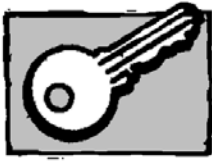
## STUDY UNIT 4.3: FRAUD PREVENTION AND DETECTION



### 4.3.1 INTRODUCTION

In this study unit we deal with the prevention and detection of fraud in organisations from a practical point of view. With the internal auditing standards as the basis, we discuss different methods and criteria that can be used to prevent and detect fraud in an organisation.





#### 4.3.2 FRAUD PREVENTION

The best action to take against fraud is prevention. Fraud flourishes in an environment where it is tolerated and where the measures introduced to combat it are not strict enough. Fraud is infectious. If members of staff realise that it is tolerated, more of them will attempt it. An organisation that does not follow a strict policy against fraud may unconsciously tend to employ dishonest people, thus further increasing the risk to it.

**Fraud prevention** involves those actions taken to discourage the commission of fraud and limit fraud exposure when it occurs.

The most important measure in the prevention of fraud is control, and the primary responsibility for the introduction and maintenance of control procedures rests with management.

Internal auditors contribute to the prevention of fraud by evaluating the adequacy and effectiveness of the internal control system in relation to the degree of exposure and risk that exists in the different segments of an organisation.



#### **The responsibility of internal auditors in deterring fraud**

The responsibility of internal auditors in deterring fraud is set out mainly in the internal auditing standards and is based on the requirement that internal auditors should exercise due professional care in the execution of internal audit assignments.

Internal auditors are not expected to possess the knowledge of someone whose primary responsibility it is to detect and investigate fraud and it is accepted that basic internal audit procedures will not necessarily lead to the detection of fraud.

Certain specific requirements are, however, laid down regarding the internal auditor's responsibility for the prevention, detection, investigation, reporting on and following up of fraud, and these will be discussed in greater detail in the study units that follow.



### **Management's responsibility for controlling fraud**

The environment in an organisation is generally developed and maintained by senior management and the board of directors. To deter fraud, the environment should be a rigorous one. Management should clearly indicate in written policies its commitment to fair dealing, its position on conflict of interest, its requirement that only honest employees be hired, its insistence on strong internal controls that are well policed and its resolve to prosecute the guilty.

The policy should be carefully drafted, with input from the organisation. The following should be taken into account when establishing a fraud policy:

- All illegal activity, including fraud for the benefit of the organisation, is prohibited.
- The responsibility for conducting investigations will be clearly defined. Usually this is assigned to security or internal auditing or both.
- Any employee suspecting wrongdoing is required to notify immediately his or her superiors or those responsible for investigations.
- Any suspected wrongdoing will be investigated fully.
- All suspects and perpetrators will be treated consistently, regardless of the position held or length of service.

- Managers are responsible for being aware of exposures to wrongdoing and for establishing controls and procedures to deter and detect suspected wrongdoing.
- Managers are required to cooperate fully with law enforcement and regulators, including reporting to law enforcement and supporting prosecution.
- Cover-ups and retaliation against witnesses will be reported to the board of directors audit committee.

One of the most effective ways of deterring dishonest conduct is to not hire dishonest employees. The least management can do is to try to verify backgrounds. Senior management should insist on proper hiring practices; internal auditors should establish whether those practices are carried out as intended.

It is the responsibility of the management of an organisation to spell out the organisation's attitude towards fraud in the form of a written policy and to communicate it clearly to all employees. Management should also delegate the necessary authority to the internal auditors to enable them to discharge their responsibilities with regard to fraud.

Every organisation should have an ethical code with which employees are required to comply and the disciplinary procedures that follow any breach of the ethical code should be known to all employees.

The King report on corporate governance, which is published by the Association of Directors in Southern Africa, provides that every organisation's ethical code should be implemented as part of that organisation's corporate control.

The best mechanism for controlling fraud is a strict and efficient internal control system. Management is responsible for establishing and maintaining an organisation's internal control system and is also responsible for controlling the functions within the organisation.

Management can use the following operational methods to exercise control over the functions within the organisation:

- organisation
- policy
- procedures
- personnel
- accounting
- budgets
- reporting



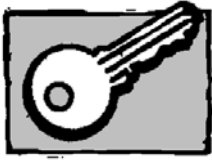
Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 8:

- Fraud prevention



- Apply the provisions of the internal auditing standards with regard to the prevention of fraud.
- Determine management's responsibility for controlling fraud.
- Determine the responsibility of internal auditors in deterring fraud.



### 4.3.3 FRAUD DETECTION

Fraud has two characteristics that contribute to its **detection**. In the first place, fraud cannot be undone once it has taken place, despite the most determined efforts to conceal it and, secondly, fraud is always committed with a view to deriving direct or indirect financial advantage. The detection of fraud involves identifying sufficient indications that fraud has taken place, so that a formal investigation can be recommended. Indications that fraud has taken place can come to light through the successful operation of internal controls geared to the detection of fraud, through audit tests carried out by the internal auditors or through other sources, either inside or outside the organisation.



#### **Provisions of the internal auditing standards that relate to the detection of fraud**

The internal auditing standards focus mainly on the internal auditor's responsibility as regards the detection of fraud. The internal auditor's responsibility arises from the requirement that internal auditors should exercise due professional care and competence in the performance of every audit project. Due care implies that the internal auditor should carry out a reasonable amount of investigation and verification, but not that he should audit every transaction in detail.

Consequently, internal auditors cannot provide the assurance that no fraud or irregularities have taken place at an organisation. Nevertheless, the possibility of irregularities and fraud should always be considered when an internal auditor undertakes an internal audit assignment.



Study the following section carefully:

- International Professional Practice Framework (IPPF), Attribute Standard 1220 together with the related Practice Advisory 1220-1



### **Practical considerations relating to the fulfilment of the internal auditor's responsibilities regarding the detection of fraud**

The possibility of fraud is one of the risk factors that threatens the achievement of the goals of management. The principal function of internal audit is to support management in the economic, efficient and effective achievement of their goals. To fulfill this function properly, the internal auditor should:

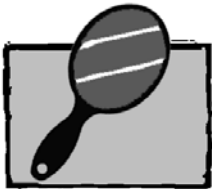
- have sufficient knowledge of fraud to be able to identify the signs that point to the existence of fraud
- be alert to conditions such as weaknesses in internal control that could allow fraud to be committed
- have a knowledge of the procedures that should be followed when there is any suspicion that fraud has taken place



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 8:

- Implications for internal auditors and others
  - Professional skepticism, professional judgement and forensic technology
  - Use of fraud specialists



### **Sufficient knowledge of fraud**

The internal auditor must understand the concept of fraud, as dealt with in study unit 5.1 of this topic.

The internal auditor must have a knowledge of the forms fraud can take in practice. The different forms of fraud, with explanatory examples of each, are dealt with in study unit 5.1 of this topic as well.

### **Be alert to conditions that could allow fraud**

The internal auditor should have a thorough knowledge of internal control systems and of the minimum internal controls that should be in operation in each organisation and system to ensure good control. When an internal auditor realises that basic controls have not been implemented or applied, or if he establishes that a system is being manipulated to circumvent internal controls, he or she should be on the look-

out for fraud and should perform additional audit tests in order to determine whether fraud is taking place or has taken place. Irrespective of the results of these tests, identified deficiencies in internal control systems that encourage fraud should be reported to management in writing.

### **Knowledge of the procedures to follow when fraud is suspected**

Every internal auditor should be trained to take the following basic steps whenever there is a suspicion that fraud has taken place:

- First, any internal auditor who is not the senior on the audit project should inform the supervisor or the internal auditor responsible for the internal audit project of his or her suspicion that fraud may have taken place.
- The factors that point to fraud should then be evaluated to determine whether any further action is necessary and whether a fraud investigation should be instituted.
- If the conclusion is reached that fraud may well have taken place, the managers concerned should be informed and the internal auditors can then recommend the investigative procedures they consider necessary.
- Last, the cause of the possible fraud should be identified, suggestions for rectifying it should be made and the internal auditors should ensure that management either pays the necessary attention to the problem or accepts responsibility if they fail to tackle the problem.

When an internal auditor suspects that fraud has taken place and is attempting to trace it, he should be aware that some courses of action are permissible and others are not.





Course of action the internal auditor should follow:

- Internal auditors should always be aware of their responsibilities regarding fraud, namely to determine what happened, how it happened, and what can be done to prevent it from happening again in the future. Tracing company assets and punishing the offenders are not matters that concern the internal auditor.
- If an internal auditor comes across an activity that may possibly be fraudulent, he or she should approach the matter cautiously.
- Before discussing the matter with anyone other than the audit supervisors, the internal auditor should do the following without delay:
  - Verify all information and vouchers to ensure that all the information is correct and can be proved.
  - Keep all information and suspicions confidential. Take full and accurate notes of everything that is done, but do this carefully.
  - Obtain and take possession of all documents that relate to the transaction and place them in safekeeping.
  - Evaluate similar transactions for a particular period to see whether there have been any repetitions of the incident and whether similar incidents have taken place.
  - Test all transactions made by the person suspected of fraud during a particular period.
  - Review all available information and carefully determine what occurred,

study all evidence and decide what possible conclusions could be based on the information.



What the internal auditor should **NOT** do:

- Do not jump to conclusions.
- Do not make any accusations.
- Do not entertain the idea that any specific person is involved in a crime; on the contrary, until it has been proved in court the internal auditor should not even create the impression that an irregularity has taken place.
- Do not get involved in an informal discussion about the information, not even with the other members of the internal auditing staff.



Study the following section carefully:

- International Professional Practice Framework (IPPF), Practice Advisory 2440-2



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 8:

- Fraud detection



- Apply the provisions of the internal auditing standards that relate to the detection of fraud.
- Apply your knowledge of the practical considerations relating to the fulfillment of the internal auditor's responsibilities regarding the detection of fraud.
- Determine the warning signs that could point to fraud.



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## STUDY UNIT 4.4: FRAUD INVESTIGATIONS



### 4.4.1 INTRODUCTION

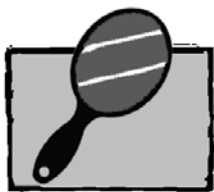
The transactions and activities that the auditor examines when conducting a fraud investigation are usually isolated transactions involving only one person or a small group of people. Each problem is unique and requires special analysis.

Fraud investigations, like all other internal audit projects, should be approached in a structured manner in order to ensure the best results for the organisation. In this study unit we discuss the nature of the internal auditor's responsibility once it has been decided to carry out a fraud investigation and the practical aspects of fraud investigations. The procedures that should be followed when conducting a fraud investigation are discussed, as are different matters that internal auditors should attend to when they have to participate in fraud investigations.



As soon as the internal auditor has established the presence of fraud of a nature that requires investigation, he should report this to the most senior executive manager at the organisation. The next step is to decide what kind of investigation will be carried out, and in what depth, and also what resources will be used in the process. This decision should be taken by senior management. Fraud investigations are time-consuming, intensive and demanding and they frequently require specific technical knowledge or experience of the operating environment in which the fraud occurred. Depending on what management decides, the internal auditor will be involved to a greater or lesser degree in fraud investigations.

#### **4.4.2 THE PRACTICAL PERFORMANCE OF FRAUD INVESTIGATIONS**



There is a big difference between the objectives of a fraud investigation and the objectives of other internal auditing projects.

In a normal auditing project, the internal auditor's tasks consist of the following:

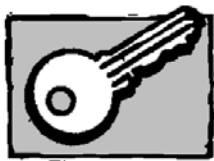
- Looking for symptoms that indicate that problems may exist.
- Looking for weaknesses in the system, or susceptibility of the system to problems.

- Making recommendations for improving efficiency, economy and effectiveness.
- Reassuring management.
- Emphasising compliance with developed procedures and controls and improving them.

In contrast with the normal internal audit, a fraud investigation is geared to detection.

In a fraud investigation, the internal auditor's tasks involve the following:

- Looking for evidence supporting an identified irregularity.
- Determining the particulars of the irregularity.
- Quantifying the loss or scope of the problem and the period in which it took place, the method used and the people involved.
- Acting as a gatherer of information and evidence.



A general programme for fraud examiners should, at a minimum, include the following:

1. Collecting industry data: This includes general information as to how the industry performs relative to financial and nonfinancial operations.
2. Financial analysis: Included here is financial analytical data for the organisation as compared to other organisations in the industry. Techniques that should be used are:
  - ratio analysis
  - vertical analysis
  - horizontal analysis
  - nonfinancial data (comparisons of different parts of statements, financial and operational, that should have a relationship)

- cash flow information
- net income adjustments (depreciation, receivables, amortisation tables etc)

3. Reviewing of internal controls: The determination that:

- Transactions are executed as per management authorisation.
- Transactions are properly recorded.
- Safeguarding of assets.
- Conformance of assets to records.

4. Evidence gathering: Techniques to be used to gather evidence about fraudulent activities. Examples are:

- interviewing
- internal control charts and visual comparisons
- document examination
- employee searches
- investigation (close supervision of suspects during an examination period)
- observation (spying or snooping)
- undercover
- specific items; collection of evidence related to the fraud

5. Evaluating: Analysis of evidence to determine if fraud actually occurred.

6. Reporting of findings to appropriate parties.



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 8:

- Fraud investigation and corrective action
  - Receiving the allegation
  - Evaluating the allegation
  - Investigating protocols
  - Corrective action

#### 4.4.3 REPORTING AT THE CONCLUSION OF A FRAUD INVESTIGATION

On completion of a fraud investigation the internal auditors should issue a formal, written report that contains all observations, conclusions, recommendations and corrective actions taken.

A preliminary copy of this report should be handed to the legal advisors for evaluation.

The basic principles of reporting on the finalisation of audit projects also apply to reporting at the conclusion of a fraud investigation.



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 8:

- Communicating fraud audit outcomes



Read through the Practice Guide – Internal Auditing and Fraud

<https://na.theiia.org/standards-guidance/recommended-guidance/practice-guides/Pages/Internal-Auditing-and-Fraud-Practice-Guide.aspx>



***This is an example of a comprehensive question that covers what we have discussed in this topic.***

The following incident in the maintenance division came to your attention recently:

One of the maintenance team leaders, John Smit, has for the past year been adjusting his staff's overtime hours on the overtime claim forms. As a result, his staff received more remuneration than staff in other teams. Being a team leader, John could never claim overtime remuneration for himself, but by "looking after his staff" as he described it, he motivated them and retained them, putting his team in a position to deliver excellent turnaround times.

A team leader from another team who stood in for John while he was on sick leave became suspicious and reported his suspicions to the departmental head.

While busy with the investigation into the allegations made against John Smit, you received the following anonymous message on the fraud hotline:

*"I noticed that some of the orders for paint are delivered to a new address. Have you opened a new warehouse or storage place recently?"*

Preliminary investigations into this matter revealed the following:

- The staff of the maintenance department is divided into four teams, each team with its own team leader. All the roads are painted and maintained according to a schedule prepared by the departmental head.



- The stock controller is responsible for ordering the paint and distributing it to the various team leaders on a weekly basis. Lately there has been a shortage of paint and some of the teams are currently behind schedule.
- All the painters are appointed on a contract basis and they are paid per hour. The painters work a considerable amount of overtime to ensure that there are minimum disruptions caused to peak-time traffic.
- The stock controller is also responsible for the stock takes and the final paint inventory figures. After attending the stock take it became clear that there were shortfalls in the paint on hand figures and that numerous corrections were made to the paint inventory figures.
- The stock controller, Jack Smit, has been the stock controller for the past ten years. The head of the division mentioned that Jack Smit is related to John Smit, one of the team leaders in the maintenance division.
- Over the past few years Jack Smit has declined various opportunities for promotion on the grounds that he does not want to take on any additional responsibilities. The divisional head also mentioned that Jack has a balance of more than 100 days of leave available to him because Jack never takes annual leave (as he is so committed to his work). One of the staff members revealed that Jack and John recently opened a small business on the side, selling paint to members of the public. Since the start of this sideline business, extravagant lifestyle changes have been noted in both John and Jack Smit's personal lifestyles.

## **REQUIRED**

1. Discuss whether or not John Smit's actions pertaining to the overtime claims would be regarded as fraud according to the South African definition of fraud.
2. List five (5) red flags that could suggest that fraud is being committed.

3. Briefly discuss the factors that motivate people to commit fraud.



1. **Whether or not John Smit's actions with regard to overtime claims would be regarded as fraud in the context of the South African definition of fraud**

John Smit's actions can be seen as fraud in terms of the South African definition of fraud as all four elements of fraud are present. Both the intention to deceive as well as the intention to defraud the company are present in John Smit's behaviour.

1. John **misrepresented** information by making unauthorised changes to the claim forms of the employees working for him.
2. The company incurred financial losses by paying excessive overtime for work not performed; the financial loss is referred to as **prejudice**.
3. Any fraudulent misrepresentation is **unlawful**. Any unauthorised changes made to the claim forms can be seen as unlawful.
4. John Smit's actions were **intentional** as he knew that they would lead to unauthorised payments made to individuals, which could lead to financial losses.

2. **Red flags that could indicate the possibility of the theft of paint**

- shortfalls in the paint-on-hand figures
- recent shortage of paint
- numerous corrections to the paint-on-hand figures
- delivery of paint to a new address
- John and Jack Smit's dramatic lifestyle changes
- Jack Smit not taking leave

- Jack Smit declining several opportunities for promotion

### 3. Factors that motivate people to commit fraud

- Firstly, there may be pressure on the individual, either internal pressure in the form of debt or a desire for riches, or external pressure in the form of pressure exerted by the organisation on management to achieve projected profit figures and adhere to budgets.
- Secondly, opportunity in the form of uncontrolled access to organisational assets tempts employees to misappropriate them for their own profit.
- Thirdly, personality disorders (lack of ethics) may exist. Most people generally prefer to be honest, but unfortunately there are the exceptions who prefer to be dishonest.



#### Notes

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In this topic we discussed the nature and elements of fraud. We saw that fraud takes many forms in practice. We identified the factors that motivate people to perpetrate fraud.

In this topic we also covered fraud risk, fraud risk assessment and the governance over the fraud risk management programme. We established that fraud risk is the probability that fraud will occur and the potential consequences to the organisation when it occurs. A fraud risk assessment is a critical component of an organisation's larger enterprise risk management programme. We also discussed the important

role of management in providing oversight for the successful completion of a fraud risk assessment so that management has a better understanding of fraud risks and the controls in place to mitigate those risks.

We studied the execution of the internal auditor's basic responsibilities in terms of the internal auditing standards with regard to the prevention and detection of fraud. We noted that prevention is the most important step in deterring fraud, that management has the most important part to play and that the internal auditors support management in discharging their responsibility by evaluating existing procedures through investigation and testing.

We looked at the internal auditor's responsibility in fraud investigations. We explained certain aspects of the process of investigating fraud and dealt with some of the considerations to bear in mind when conducting a fraud investigation.

## TOPIC 5: INFORMATION SYSTEMS AUDITING



### INTRODUCTION AND PURPOSE OF THE TOPIC

The accounting of an internal control system of an entity is influenced by a computerised information system. A computerised information system environment is any environment where a computer, of any type or size, is used in the processing of financial information.

A computerised information system environment influences the procedures followed by an auditor in the following respects:

- the audit procedures that need to be carried out in order to acquire a sufficient understanding of the accounting and internal control systems of an organisation
- the factors to be considered in respect of the inherent and control risk of an organisation in order to reach a decision on the audit risk the auditor is prepared to accept
- the design and execution of audit procedures in order to achieve the audit objectives



## LEARNING OUTCOMES

**After you have studied this topic, you should be able to:**

- explain the concept of computer assisted audit techniques and integrate them at a multi-disciplinary level
- describe the advantages and disadvantages of computer assisted audit techniques
- describe the conditions which indicate that the use of computer assisted audit techniques is appropriate and be able to integrate your knowledge of computer assisted audit tools and techniques (CAATS) with your prior knowledge of auditing
- describe the factors that auditors should consider if they intend to use CAATS in performing an audit
- explain and investigate the background information and definitions of advanced IT environments in relation to the audit process
- evaluate advanced IT systems and applications in the development of the audit approach
- explain the risks related to new or developed IT systems and identify potential risks in a given scenario
- explain the organisational risks and controls relating to IT systems that are developed in-house or purchased externally
- demonstrate your knowledge and comprehension of the internet and the risks associated with the internet
- apply the controls which address the risks of an internet connection
- explain what information system security is

## CONTENT OF THE TOPIC

The following study unit will be covered in this topic:

Study unit	Title
5.1	Computer audit process
5.2	Computer risk
5.3	Control activities
5.4	Computer assisted audit techniques
5.5	Auditing advanced and new IT systems
5.6	Auditing security and privacy of information assets

## STUDY UNIT 5.1: COMPUTER AUDIT PROCESS



### 5.1.1 INTRODUCTION

Auditing may take different forms, such as IS, internal or external auditing in the private or public sectors.

IS auditing involves the planning of a specific audit to ensure that the IT audit strategy and objectives are achieved and that audit evidence is obtained that is sufficient, reliable, relevant and useful for the purposes of attaining the audit objectives.

### 5.1.2 INTRODUCTION TO THE IT AUDIT PROCESS

A computer information systems environment exists when a computer of any kind or size is used in the processing of an entity's financial or other information. The use of a computer influences the generation of transactions, their processing, and the storage and communication of information. The use of computers may have an influence on the accounting and internal control systems. Computer information systems do not alter the necessity for internal control systems. They do not affect the objectives of internal control or the need to apply auditing standards.

Please note that in this study unit we only provide an overview of the IT audit process.

STEP 1: PRELIMINARY ACTIVITIES	
<b>Gather organisational information</b>	<ul style="list-style-type: none"><li>• This information will serve as a basis for creating the audit plan.</li><li>• The organisation's strategy and responsibilities for managing and controlling computer applications will be identified.</li><li>• Obtain general data about the company, identify financial application areas and prepare an audit plan.</li></ul>



STEP 2: AUDIT PLANNING PROCESS	
Proper planning will ensure that the audit is conducted in an effective and efficient manner.	
<b>The planning process involves</b>	<ul style="list-style-type: none"><li>• Identifying the tasks to be performed in the course of an audit.</li><li>• Allocation of those tasks to specific auditors.</li><li>• Deciding when a task should commence.</li><li>• Quantification of the duration of each individual task based upon the auditor allocated.</li></ul>
<b>An audit should include</b>	<ul style="list-style-type: none"><li>• Tentative determination of the objectives and scope of the audit.</li><li>• Determine overall business objectives of area to be reviewed as well as control objectives.</li><li>• For each key performance area (KPA), performance objectives must be established.</li><li>• Reviewing the design of internal control system for</li></ul>



	<p>adequacy, tests of compliance with designed control system and evaluation of the effectiveness of the implementation of the control system.</p> <ul style="list-style-type: none"> <li>• Selection of audit team.</li> <li>• Initial communication with auditees and others involved.</li> <li>• Preparations of preliminary audit program.</li> <li>• Planning of audit report.</li> <li>• Approval of audit approach.</li> </ul>
<b>Structure of the plan</b>	<ul style="list-style-type: none"> <li>• Preliminary survey – gain an initial understanding of the operations.</li> <li>• Internal control description and analysis – preparation of detailed descriptions of the internal controls relating to the area under review.</li> <li>• Expanded tests – tests that would be included in the final audit program.</li> <li>• Findings and recommendations – develop findings and recommendations to improve the internal controls.</li> <li>• Report production – includes documenting and communicating the final results.</li> </ul>



<b>STEP 3: EVALUATION OF INTERNAL CONTROLS</b>	
<b>Define internal control</b>	<ul style="list-style-type: none"> <li>• COSO defines internal control as “a process, influenced by an entity’s board of directors, management, and other personnel that is designed to provide reasonable assurance in the effectiveness and efficiency of operations, reliability of financial reporting and the compliance of applicable laws and regulations”.</li> </ul>
<b>Evaluate the five control components</b>	<ul style="list-style-type: none"> <li>• <i>Control environment</i> – management’s philosophy and operating style</li> <li>• <i>Risk assessment</i> – risk identification and analysis</li> <li>• <i>Control activities</i> – policies and procedures implemented in the organisation. The following controls should be implemented by an organisation: <ul style="list-style-type: none"> <li>- preventive controls – controls intended to stop and error from occurring</li> <li>- detective controls – controls that detect whether an error has occurred</li> <li>- mitigating controls – control activities that mitigate the risks associated with key controls</li> </ul> </li> <li>• <i>Information and communication</i> – Ensure that all important information is obtained and communicated throughout the organisation.</li> <li>• <i>Monitoring</i> – review output generated by control activities.</li> </ul>

<b>Evaluation of general and application controls</b>	<ul style="list-style-type: none"> <li>• General controls cover the entire CIS environment within which each set of application controls functions. General controls are related to all applications and provide a framework within which the CIS department exercises control over the development, operation and maintenance of individual applications.</li> <li>• Application controls are user and programmed controls and are embedded in each of the data processing functions, namely input, processing and output.</li> <li>• Refer to study units 5.2 &amp; 5.3 under topic 5.</li> </ul>
<b>Tests of control</b>	<ul style="list-style-type: none"> <li>• Determine the effectiveness of the operation of internal control.</li> <li>• Determine whether the design of the control is such that the control prevents material errors from occurring.</li> <li>• Assess how the control was applied, whether the control was applied consistently and who applied it.</li> <li>• The main focus is to re-perform the application of the controls themselves.</li> </ul>



<b>STEP 4: FIELDWORK - AUDIT PROCEDURES</b>	
<b>Define audit procedures</b>	<ul style="list-style-type: none"> <li>• Tasks/audit tests performed by the auditor to gather evidence to ensure that the audit objectives are met.</li> </ul>
<b>Audit evidence</b>	<ul style="list-style-type: none"> <li>• Evidence is obtained to support the final conclusions of the audit.</li> <li>• Audit evidence should be reliable, sufficient, relevant and useful in order to support findings and conclusions.</li> <li>• All audit evidence should be documented to support findings.</li> <li>• The following procedures can be used to obtain audit evidence: <ul style="list-style-type: none"> <li>- enquiry</li> <li>- observation</li> <li>- inspection</li> <li>- reperformance/calculation</li> <li>- monitoring/analysing</li> <li>- CAATs</li> </ul> </li> </ul>
<b>Audit sampling</b>	<ul style="list-style-type: none"> <li>• Application of an audit procedure to less than 100% of the population in order to evaluate audit evidence.</li> <li>• Sampling risk is the risk that the conclusion reached may be different from the conclusion that would be reached if the entire population were tested.</li> </ul>

	<ul style="list-style-type: none"> <li>Sampling objectives as well as the sampling method used must be documented in the audit working papers.</li> </ul>
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<b>STEP 5: COMPLETING THE AUDIT</b>	
<b>Reporting</b>	<ul style="list-style-type: none"> <li>All findings are disclosed in the audit report issued to management. For each finding recommendations should be provided.</li> </ul>
<b>Written reports</b>	<ul style="list-style-type: none"> <li>Refer to page 135 of the textbook for details on the requirements for a written report.</li> </ul>
<b>Basic audit report</b>	<ul style="list-style-type: none"> <li>The contents of the audit report includes the following: <ul style="list-style-type: none"> <li>- Background, scope and objectives</li> <li>- Summary of major findings</li> <li>- Audit opinion</li> <li>- Detailed findings and recommendations</li> <li>- Acknowledgements of satisfactory performance</li> <li>- Detailed technical appendices</li> </ul> </li> </ul>
<b>Audit documentation</b>	<ul style="list-style-type: none"> <li>Working papers should include all of the following: notes, documents, flowcharts, correspondence, plans and results of tests, etc.</li> <li>Working papers should support the findings and recommendations stated in the report.</li> <li>Working papers should be evaluated by a partner or manager on the basis of the following: completeness, accuracy, appropriate findings and recommendations, follow-up to findings and recommendations.</li> </ul>
<b>Follow-up activities</b>	<ul style="list-style-type: none"> <li>The auditor should ensure that appropriate action was taken to address the findings raised in the report.</li> <li>The nature, timing and extent of follow-up activities should be taken into account, as well as the impact on the organisation if corrective action is not taken.</li> </ul>



You are the audit senior on an IT audit. One of the junior auditors asks you to explain the following with regard to the IT audit process:

- What are the steps that should be followed when performing an IT audit?



You would mention the five different steps of the IT audit process and give a short description of each step. Refer to steps 1 to 5 above.



### Notes

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## STUDY UNIT 5.2: COMPUTER RISK



### 5.2.1 INTRODUCTION

In this study unit will we discuss the following risks and threats in a computerised environment:

- Computer risks and exposures
  - Inherent risk
  - Control risk
  - Detection risk
  - Audit risk
- Computer system threats
- Controls

## 5.2.2 COMPUTER RISKS AND EXPOSURES

### **Definition of risk**

*The uncertain event that could influence the achievement of the organisational objectives.*

### **Types of risk**

There are three risks that need to be considered when using a risk-based audit approach. They are inherent risk, control risk and detection risk, which is known as audit risk.

#### ***Inherent risk***

*Inherent risk is the likelihood of a significant loss occurring before taking into account any risk-reducing factors.*

In evaluating inherent risk, an auditor should consider what the types and nature of risks are and what factors indicate that a risk exists.

#### ***Control risk***

*Control risk is the likelihood that the control processes established to limit or manage inherent risk are ineffective.*

In order to ensure that an auditor evaluates the controls properly, the auditor requires an understanding of how to determine which controls are effective. This will involve identifying those controls that provide the most assurance that risks are being minimised within the business.

It is quite clear from the descriptions of inherent and control risk that when the risk approach in the conduct of an audit is followed, these are the risks that should serve as the basis for assessing exposure to risk.

#### ***Audit risk***

Audit risk is not a type of audit approach, but rather an audit concept. This concept is, however, related to aspects of auditing risk and is defined as follows in Puttick and Van Esch (2003:138-144):

*Audit risk is the risk that audit coverage will not address significant business exposures.*

*Audit risk consists of three components, namely **inherent risk**, **control risk** and **detection risk**.*

The total audit risk is determined by means of the following formula:

**AR (audit risk) = IR (inherent risk) x CR (control risk) x DR (detection risk)**

### ***Detection Risk***

Detection risk is the risk that if a material problem that would affect the conclusion pertaining to an audit objective has occurred, the auditors will not find it.

This might arise because entries and activities are not fully examined.

### **Controls**

In order to be able to evaluate internal controls and make recommendations on possible weaknesses and suggest improvements to internal control systems, internal auditors require a thorough knowledge of and extensive insight into control activities and the related internal control measures. General and application controls will be discussed in study unit 5.3 of this module.

### **Computer system threats**

Threats may come from external or internal sources and may be intentional or unintentional as well as malicious or non-malicious. Internal threats may come from users, management, IS staff, IS auditors and others, acting alone or in collusion.

**Top 10 Technology Risks issued as identified by the IIA advanced technology committee**

1. Legislation and Regulatory Compliance
2. Threat / vulnerability management (Application exploits, viruses, Trojans, worms etc)
3. Privacy (including identity protection)
4. Continuous monitoring / auditing / assurance
5. Wireless security
6. Intrusion protection ( firewalls, monitoring, analysis etc)
7. IT Outsourcing
8. Enterprise security metrics (dashboards, scorecards, analytics etc)
9. Identity management
10. Acquisition and Divestitures – impacts on system management

*The institute of Internal Auditors, Advanced Technology Committee Meeting, Dec.2005*



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 7:

- Key components of modern information systems.
- IT opportunities and risks
  - Opportunities enabled by IT
- IT Risk Management



- Distinguish between inherent, control, audit and detection risk.
- Mention and discuss internal computer system threats.



**Notes**

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## STUDY UNIT 5.3: CONTROL ACTIVITIES



### 5.3.1 INTRODUCTION

The actual internal controls introduced in organisations in order to attain the internal control objectives can be related to certain generally applicable control activities.

In order to be able to evaluate internal controls and make recommendations on possible weaknesses and suggest improvements to internal control systems, IT auditors require a thorough knowledge of and extensive insight into control activities and the related internal control measures for computerised information systems (CISs).

### 5.3.2 CONTROL ACTIVITIES

#### Control

A control may be defined as “*any action taken by management to enhance the likelihood that established objectives and goals will be achieved.*” Controls are the responsibility of management. It is up to them to ensure effective and efficient controls by planning, organising and directing.

Within the IT environment management should ensure that:

- systems function as planned;
- that data integrity is maintained;
- information and data are confidential;
- that systems and information are available when needed;
- data is accurate, complete and valid; and



- access to systems and programs are only granted to authorised users.

### **Internal controls**

It is the task of management, and not the auditor, to design and implement effective internal control systems in order to manage business risks and ensure that attention is paid to all aspects of control.

If you were introduced to the principles of business management in the past, you will remember the following elements of management:

- planning
- organising
- directing
- controlling

Internal control, as an element of overall control, is therefore regarded as an element of management.

Internal control is defined as *the process designed and effected by those charged with governance, by management, and by other personnel to provide reasonable assurance about the achievement of organisational objectives regarding the following three categories:*

- *the reliability and integrity of financial reporting*
- *the effectiveness and efficiency of operations*
- *compliance with applicable laws and regulations*

Internal control in a computer environment is achieved by implementing and maintaining **general controls** and **application controls**. Each category would probably include user (manual) and programmed (computerised) controls.

Internal control is designed and implemented in order to deal with business risks that could endanger the achievement of any of the above organisational objectives.

## **System of internal control**

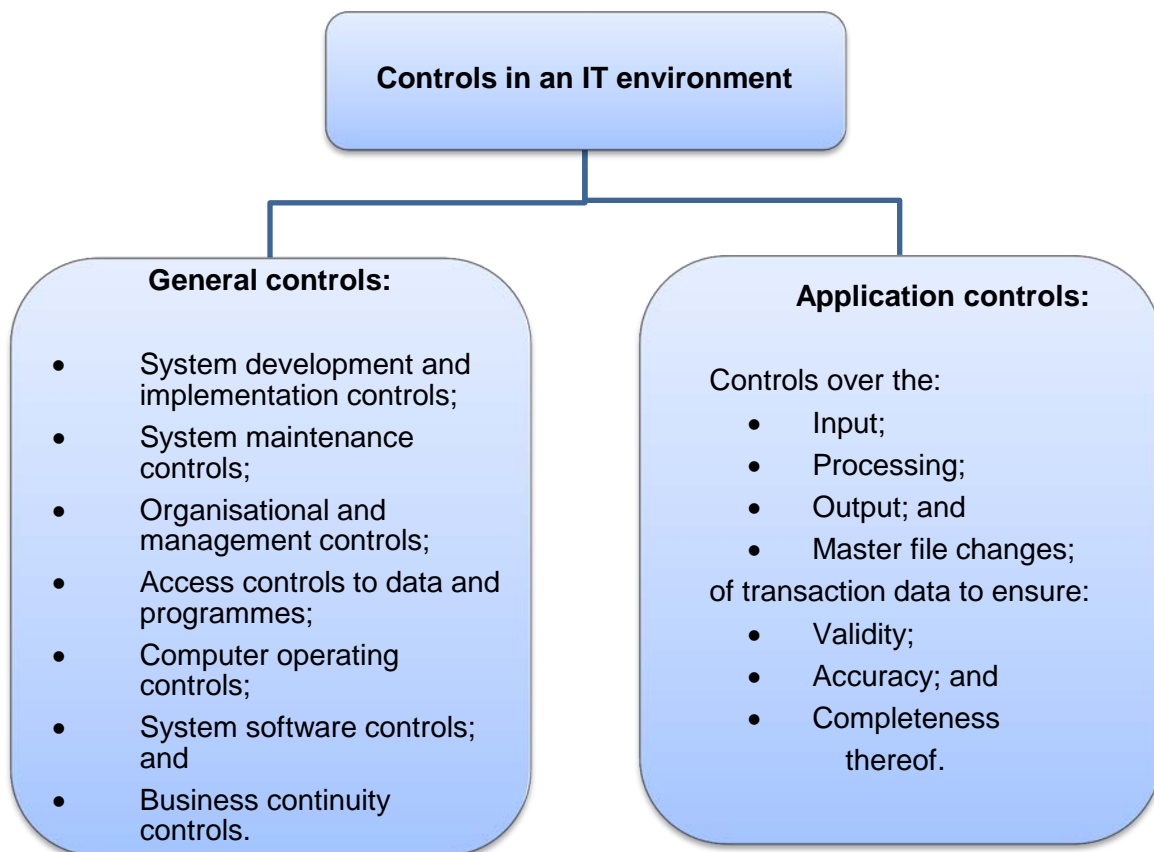
System of internal control – a combination of the individual elements of control.

The object of such a system of control is to ensure that -

- the computer system is properly developed, implemented and maintained
- proper controls are in place to ensure the **validity, completeness** and **accuracy** of transactions and data

Below is a framework setting out the **general and application controls**.

**These are the main categories of controls in an IT environment.**



Certain controls fall under both general and application controls. Access controls apply to both categories, as illustrated below.

- **General controls:** to control access to data and programs
- **Application controls:** to control access to specific program functions to ensure the validity of input, processing and output

Control structures must be designed to ensure:

- Segregation of duties
- Competence and integrity of people
- Appropriate levels of authority
- Accountability
- Adequate resources
- Supervision and review

### 5.3.3 CONTROLS IN AN IT ENVIRONMENT

Internal control in an IT environment is achieved through the implementation and continuance of both **general controls** and **application controls** (both of these are explained in detail below).

These controls have two main objectives, i.e. to ensure that:

1. the IT system is sufficiently developed, implemented and maintained (**general controls**);
2. the sufficient controls are in place to ensure valid, complete and accurate data and transactions (**application controls**).

It is important to note that assurance must be provided by the IT controls within the system of internal controls. It should be continuous and a dependable audit trail has to be provided. The auditor depends on the internal controls for assurance, but his assessment thereof is independent and objective. This assessment will include obtaining an understanding of this control environment, examining it and assessing the key controls on which reliance is placed. The main objective of the testing performed by the auditor on this environment, is to ensure that these controls are designed correctly and that they are functioning effectively, efficiently and continuously.

As these controls can range from simple to extremely technical, the auditor has to interact very closely with the IT staff of an entity and the persons in positions of responsibility to enable him/her to gain a proper understanding of the controls.

The IT environment on an entity is not static and changes with new IT technologies, changing requirements, strategies, risks, new business processes etc. For the auditor this creates difficulties as the audit of an IT environment requires continuous learning and re-assessment. It is therefore a continuous process. Audit plans and methods of obtaining audit assurance, should be adopted continuously to accommodate changes in the IT environment.

IT controls are needed for various reasons. These reasons include the need to control costs of the entity, the need to remain competitive in the market that the organisation is operating in and the need to comply with governance, laws and regulations.

When effective IT controls are in place, it accommodates adaptability to a changing risk environment. Risks of errors and fraud can be minimised through controls that prevent or detect and correct them. Organisational or business risks can thus be properly managed.

According to *GTAG (Global Technology Audit Guide) – Information technology controls*, the **key indicators of effective IT controls** include:

- The ability to execute and plan new work such as IT infrastructure upgrades required to support new products and services;
- Development projects that are delivered on time and within budget, resulting in cost-effective and better product and service offerings compared to competitors;
- Ability to allocate resources predictably;
- Consistent availability and reliability of information and IT services across the organisation and for customers, business partners, and other external interfaces;
- Clear communication to management of key indicators of effective controls;
- The ability to protect against new vulnerabilities and threats and to recover from any disruption of IT services quickly and efficiently;

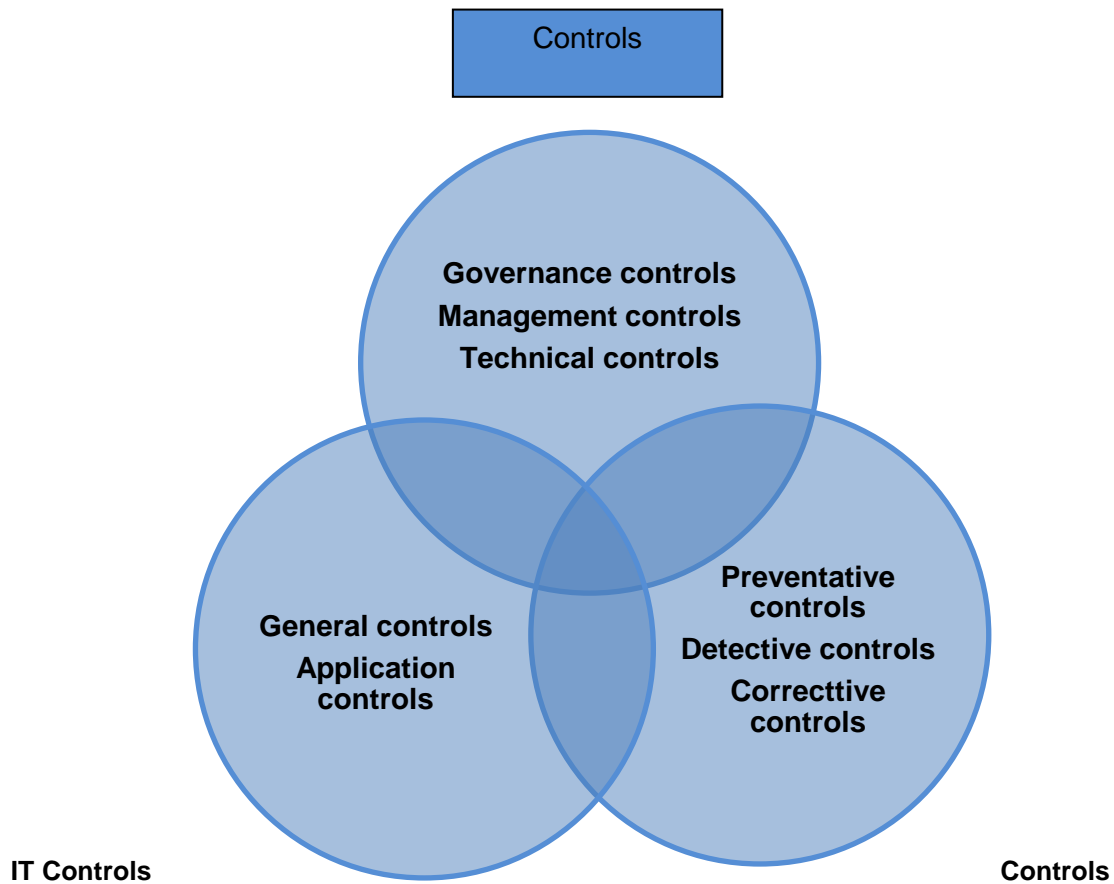
- The efficient use of a customer support centre or help desk;
- Heightened security awareness on the part of the users and a security-conscious culture throughout the organisation.

By implementing a control framework (formal or informal), an entity will be able to identify, monitor and assess IT controls that were implemented to address specific risks.

The COSO control framework can be used by the auditor when obtaining an understanding of the IT control environment. It should however be noted that controls might look good on paper, but might not be functioning as intended or not be performed at all.

IT controls support business management and governance (the automation of business controls) and they provide general as well as technical controls over policies, processes, systems, procedures etc. Proper IT controls can protect the entity against significant threats. They are essential in ensuring reliable financial processes and reporting.

Below is a diagram to illustrate that IT controls do not operate in isolation. They are mutually dependent and a weakness in one IT control could lead to a significant weakness in the entire IT environment.



## GOVERNANCE CONTROLS

According to GTAG (Global Technology Audit Guide) – Information technology controls, governance controls are explained as follows:

*“The primary responsibility for internal control resides with the board of directors in its role as keeper of the governance framework. IT control at the governance level involves ensuring that effective information management and security principles, policies, and processes are in place and performance and compliance metrics demonstrate ongoing support for that framework. Governance controls are those mandated by, and controlled by, either the entire board of directors or a board committee in conjunction with the organisation’s executive management. These controls are linked with the*

*concepts of corporate governance, which are driven both by organisational goals and strategies and by outside bodies such as regulators.*

*An important distinction between governance and management controls is the concept of “noses in, fingers out.” The board’s responsibility involves oversight rather than actually performing control activities. For example, the audit committee of the board does no auditing, but it does oversee both the internal and external auditing of the organisation.”*

## **MANAGEMENT CONTROLS**

According to GTAG (Global Technology Audit Guide) – Information technology controls, management controls are explained as follows:

*“Management responsibility for internal controls typically involves reaching into all areas of the organisation with special attention to critical assets, sensitive information, and operational functions. Consequently, close collaboration among board members and executive managers is essential.*

*Management must make sure the IT controls needed to achieve the organisation’s established objectives are applied and ensure reliable and continuous processing. These controls are deployed as a result of deliberate actions by management to:*

- *Recognise risks to the organisation, its processes, and assets.*
- *Enact mechanisms and processes to mitigate and manage risks (protect, monitor, and measure results).”*

## **TECHNICAL CONTROLS**

According to GTAG (Global Technology Audit Guide) – Information technology controls, technical controls are explained as follows:

*“Technical controls form the foundation that ensures the reliability of virtually every other control in the organisation. For example, by protecting against unauthorised access and intrusion, they provide the basis for reliance on the integrity of information — including evidence of all changes and their authenticity. These*

*controls are specific to the technologies in use within the organisation's IT infrastructures.*

*The ability to automate technical controls that implement and demonstrate compliance with management's intended information-based policies is a powerful resource to the organisation."*



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services, chapter 7:*

- IT Governance.
- IT Controls.
  - IT Governance controls.
  - IT Management controls.
  - IT Technical controls.
  - Information security controls.



### Notes

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## STUDY UNIT 5.4: COMPUTER ASSISTED AUDIT TECHNIQUES



### 5.4.1 INTRODUCTION

The use of computers is part of everyday life for most of today's auditors – they carry out and document their work using laptops and they are required, in the early stages of the audit, to obtain an understanding of their clients' accounting systems, most of which are computerised.

### 5.4.2 INTRODUCTION TO COMPUTER ASSISTED AUDIT TOOLS AND TECHNIQUES (CAATS)



#### *5.4.2.1 The concept of computer assisted audit tools and techniques (CAATS)*

In today's environment, a review of business systems will almost inevitably involve the use of appropriate information retrieval and analysis programs and procedures. Computer assisted audit tools and techniques (CAATS) are needed because of the large volumes of data in multiple locations involved in managing a complex business environment.

The use of CAATS involves merging software into an audit program. Information retrieval and analysis programs and procedures include programs that organise, combine, extract and analyse information. The ready availability of microcomputer-based software, which provides computing power without requiring technical expertise, makes direct data analysis part of the toolkit of any auditor. The primary requirement is for the auditor to have an understanding of the business application

and of how data relates to it.

The overall objective and scope of an audit do not change in a computerised information system (CIS) environment. The use of a computer does, however, change the method of recording transactions, and the processing, storage and communication of financial information. A CIS environment is any environment where a computer, of any type or size, is used in the processing of financial information.

#### *5.4.2.2 Possible uses of computer assisted audit techniques*

CAATS can be used

- to carry out various types of audit assignment
- in the execution of various types of audit procedure

The most important of these techniques, which are usually found in auditing software packages, are the following:

- the performance of the following procedures where only one computer file is used:
  - sorting or indexing of items
  - inclusion or exclusion of items
  - accounting computations
  - summarising of information
  - statistical sampling
- the performance of the following procedures in which two computer files are used:
  - the collation of information
  - the fitting or selection of information
  - the updating of information
  - the addition of information



#### 5.4.2.3 *The advantages of CAATS*

##### **General benefits**

- improved efficiency and effectiveness of individual audits and of the audit department
- ability to evaluate a larger universe and increase audit coverage
- increased analytical capabilities
- improved quality of activities performed during the audit
- consistent application of audit procedures and techniques
- increased cost effectiveness through the reusability and extensibility of computerised techniques
- improved integration of financial/information systems audit skills
- increased independence from information systems functions and greater credibility for the audit organisation
- greater opportunities to develop new approaches
- better management of audit data and working papers

##### **Benefits during the conduct phase**

- **Data analysis.** General audit software can be used to draw samples or to test

100% of the population because these tasks can be performed by the computer in a fraction of the time it would take to do them manually. Other tasks such as sorting and comparing can also be done more quickly by a computer.

- **Increased coverage.** It can take weeks to review systems containing millions of transactions manually, but with computers the auditor can analyse, sort and compare, and look for trends in thousands of transactions in minutes in order to increase audit coverage.
- **Better use of auditor resources.** Automation allows auditors to spend more time on activities in which they have to use their judgement.
- **Improved results.** The auditor is able to conduct a thorough analysis of transactions within shorter time frames which will result in improved results.

#### *5.4.2.4 The disadvantages (or reasons for the nonuse) of CAATS*

- **Too costly to purchase and maintain.** Some audit organisations believe that audit software is costly and cannot be proven to be cost effective. This may have been the case, but recently the costs have decreased substantially. Modern audit software is more flexible and can be used on a variety of applications.
- **Too technical and complex for non-IS auditors.** Modern audit software is more user friendly and can be used more freely without the assistance of programmers.
- **Client system and data compromised.** Previously audit software had to be loaded and run on the auditee's computer system. Modern technology allows auditors to download the data onto their personal computer and analyse the data on the auditee's premises.



- What is meant by the concept of computer assisted audit techniques?
- What are the advantages of computer assisted audit techniques?
- Why are auditors sometimes hesitant about using computer assisted audit techniques?

#### **5.4.3 CONSIDERATIONS IN THE USE OF CAATS**

The following conditions indicate that the use of CAATS may be appropriate:

- lack of audit trails to trace transactions to final records or to source documents
- computer printouts which are extremely voluminous and which make manual extraction, summarisation or sorting too time consuming or virtually impossible
- where information is not available in a format suitable for manual use
- where the volume of transactions is so vast that extensive testing (large samples) is necessary to obtain meaningful results
- the extent of computerisation at the auditee – the more extensive the computerisation, the more desirable the use of CAATS
- where the effectiveness and efficiency of the audit would be increased
- where detection risk would be significantly decreased as a result of more extensive testing capabilities



## **Considerations in the use of CAATS**

When an auditor first considers using CAATS in carrying out the audit process, the first step is to attend to the following factors:

- the computer knowledge, expertise and experience required to use CAATS
- the availability of suitable CAATS and suitable computer facilities
- whether it would be impractical to use ordinary (noncomputer assisted) audit techniques
- whether the effectiveness and efficiency of the audit process would be increased if CAATS were used
- the timing for the execution of CAATS
- the auditing software that will be used

## **Considerations in the implementation of CAATS**

If an auditor decides, after considering the factors mentioned above, to use CAATS, it is essential that the management of the audit firm (or of the internal audit section) should make a formal commitment to the implementation of CAATS and offer the necessary support in order to develop the required knowledge and competence for the application of CAATS.

CAATS can best be used for the following audit functions:

- Sorting and file reorganisation. Data can be sorted by date, customer name,

department name etc.

- Summarisation, stratification and frequency analysis. Data can be summarised in account number order, departmental order and the frequency with which certain items are bought and used.
- Extracting samples, exception reporting, file comparison, for example current masterfile to prior year's masterfile. These comparisons can be used to develop certain ratios to compare exceptions and deviations.
- Analytical review, for example extraction of ratios.
- Casting and recalculation.
- Examining records for inconsistencies, inaccuracies and missing data and creating reports.



- What conditions indicate that the use of CAATS is appropriate?
- What factors should the auditor consider when deciding whether to use CAATS in carrying out the audit process?
- Describe the factors the auditor should consider in the implementation of CAATS.

## **5.4.4 PLANNING FOR THE USE OF CAATS**

### *5.4.4.1 Planning considerations*

Proper planning for the use of CAATS is just as important as, if not more important than, the planning phase of the audit process where the computer is not used. In addition to ordinary planning matters, attention should be given to the matters listed below, which are of exceptional importance in the application of CAATS. The auditor should consider the following specific planning items:

- knowledge of the auditee's business
- audit plan
- data file reconciliation

#### **Knowledge of the auditee's business**

With respect to the possible audit software, the auditor should consider accumulating the following information at the planning stage of the audit:

- the impact of the auditor's access to an auditee's data, hardware, software and networks
- the main systems of financial significance, and the data retention policies, related file layouts and volumes of transactions

#### **Audit plan**

The audit plan should be reviewed to ensure that optimum use is made of the available audit software. Appropriate resources should be available to support the audit plan.

Attention should be paid to the following aspects:

- need for continuity of staff on each audit to ensure that the use of audit software increases over time
- experience of scheduled audit staff in the use of audit software



- training requirements for audit staff before the fieldwork begins
- need for, and timing of, technical support
- specialised hardware or software required to access the auditee's data
- need for auditees to retain data necessary for the audit and to ensure that the auditor is made aware of changes in, for example file structures and content

### **Data file reconciliation**

It is important to reconcile the auditee's data which are used for audit testing with the subject matter of the engagement, for example financial statements or auditee's control totals. The auditee should be asked to provide the information, such as control totals of the more important numerical fields, to ensure that all transactions were processed. It is also important to reconcile the number of records back to the source population.

#### *5.4.4.2 The consequences of inadequate planning*

The failure to plan adequately for the use of CAATS can result in

- cost and time overruns
- arriving at the wrong audit conclusion
- failure to achieve the desired objective of the test
- significant frustration to both the auditor and the auditee



- Which specific aspects should the auditor pay attention to during the planning phase when using CAATS?
- What are the possible consequences of inadequate planning when using CAATS?

#### 5.4.5 THE APPLICATION OF CAATS

CAATS can be used to do tests of controls or substantive procedures. System-oriented CAATS concentrate on the accounting system and related control procedures and data-oriented CAATS are mainly concerned with substantive testing.

The testing of controls when making use of system-oriented CAATS would be regarded as auditing through the computer.

Where the client has a computerised accounting system, it would be more effective and efficient to use CAATS in performing substantive audit procedures. This will also be regarded as data-oriented CAATS. Typical ways in which this can be done are indicated below:

- **Audit working papers**

The audit firm's audit working papers and audit methodology may be available on generally accepted audit software packages such as Caseware, ACL or IDEA. The working papers would document the audit programs and schedules, analysing account balances and significant classes of transactions in detail.

- **Substantive analytical procedures**

- ✓ CAATS may be used to download information from the computerised accounting records of the auditee and then, using spreadsheets and modelling programs, the full range of analytical procedures may be performed.
- ✓ CAATS may be used to analyse all journal entries processed during the period in order to identify all large and unusual journal entries for substantive testing. The auditor should be alert to the risk of management override of controls over non-standard journal entries and to the fact that there may be little or no visible evidence of such override.

- **Sample selection**

Sampling software can facilitate the selection of random and other samples of

source documents or transactions recorded.

- **Data sorting and analysis and printing of exception reports**

CAATS may be used to sort data within the computerised accounts according to the specifications of the auditor, for example:

- ✓ revenue transactions
- ✓ payroll transactions
- ✓ inventory listings
- ✓ re-calculation



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## STUDY UNIT 5.5: AUDITING ADVANCED AND NEW IT SYSTEMS

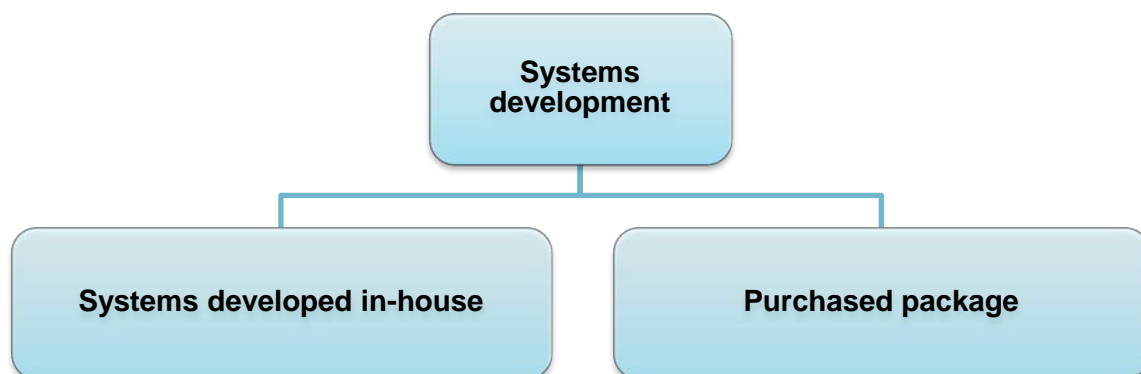


### 5.5.1 INTRODUCTION

The auditing of advanced IT systems and applications forms part of information management and usage monitoring. Management has to set measurement criteria such as evaluating service level performance against service level agreements, quality of service, availability, response time, security and controls, processing integrity and privacy. The analysis, evaluation and design information, together with data and application architecture, are evaluated as tools for the auditor.

### 5.5.2 SYSTEM DEVELOPMENT

System development refers to the development of a new computer system for the entity and it therefore has to do with a significant change in the IT system. System development is divided into systems developed in-house and externally purchased packages.



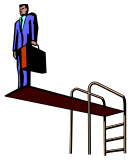
A system developed in-house is not available off-the-shelf and cannot be purchased from a retailer. It is customised to enable the entity to meet its individual needs. An example of a purchased package is when a company goes to a retailer and buys an IT accounting system such as SAP in order to accommodate its accounting functions.

When a new system is developed, the following aspects of the IT system normally change considerably:

- hardware
- software
- personnel procedures
- documentation relating to the system
- controls etc

An **example** of this is a company that has a manual system for purchasing its stock and plans to computerise this function. Implementing a computerised IT system is a

system development. The company would have to decide whether it is more feasible to develop a system in-house or to purchase a package externally.



### 5.5.3 RISKS ASSOCIATED WITH NEW OR DEVELOPED IT SYSTEMS

What are the risks (potential problems) associated with system development? When new IT systems are developed, the process might be chaotic and haphazard. This could lead to inadequate system development procedures and documentation and many problems for both the auditor and the entity.

It is crucial that the system development exercise is carefully planned and controlled. If not, the following **risks** might occur:

- System development is a costly exercise. If it is not carefully planned and controlled, costs might get out of control. This could potentially put the company under severe financial constraint.
- The new system might be susceptible to inaccurate or incomplete record keeping, for example the programs might contain errors.
- Unacceptable or inaccurate accounting policies might be incorporated into the system or important accounting policies might not be incorporated at all. The system developers (eg programmers) might not understand the accounting policies and might implement them incorrectly.
- The new system might not accommodate the needs of the users. The users might require certain functions that the new system is not able to perform.
- When transferring information from the old system to the new system, information might be lost, duplicated or incorrectly transferred (with errors).

- The new system might not have sufficient controls over access to information and the integrity of data.
- If the new system is very complex, users might find the system useless if no one knows how to operate it.
- In extreme cases, system deficiencies could result in temporary or even permanent business interruption.
- The ability to commit fraud might be deliberately or accidentally designed into the system during its development.



### **System failures as a result of poor development and implementation**

What are some of the main problems experienced during system development that could cause system failures? The following could be causes of system failures:

- poor support from top management
- poor staff attitude
- unclear business objectives
- management and users unsure of their needs
- IT personnel unfamiliar with user needs
- additional user requirements not previously specified
- changes in user requirements
- organisational changes during the project
- failure to understand interrelationships between parts of the organisation
- over-optimistic file conversions
- poor quality input for file conversions

- poor documentation
- inadequate system and program testing

#### **5.5.4 CONTROLS RELATING TO SYSTEM DEVELOPMENT AND IMPLEMENTATION**

What are **system development controls**? These are controls implemented by the entity to avoid the risks identified (which could occur during the planning, development and implementation of new IT systems).

A system developed in-house could be developed either by employees of the company (with the relevant knowledge and expertise) or it might involve the use of external consultants. Such a system caters specifically for the needs of the company as it is custom made for the entity itself and is therefore not available as an off-the-shelf package.

The main objective is to implement adequate controls which are designed to ensure that the new system is authorised, designed, developed and implemented effectively, in order to meet the needs of the users.

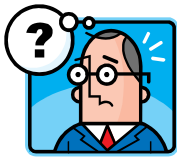
#### **Purchased packages**

Another term for purchased packages is off-the-shelf packages. This simply means that the IT system is available not only to you, but to anyone willing to buy it. This purchased IT system is unfortunately not custom made for the entity and it is often impossible to adapt for individual needs. The entity and the user have very limited control over the specifications, development, testing and design of the system. It is therefore important to look for a package that suits most of the needs so that it requires few if any changes.

Some of the advantages are the following:

- It can be installed immediately.
- The supplier of the package normally provides the relevant training.
- The supplier also offers some support.

- The costs relating to the new system can be predetermined.



### **5.5.5 THE ROLE OF THE AUDITOR IN SYSTEM DEVELOPMENT**

From the auditor's point of view, the development, implementation and documentation of a system are a crucial stage at which to emphasise control. Application controls should preferably be built into the system before it becomes operational. It should be a reliable system from the start.

Even though most entities do not involve their internal auditors in the system development process, there is a general agreement that such involvement would help ensure that systems are implemented appropriately and that the application controls built into the system operate effectively.

There are, however, two schools of thought with regard to the involvement of the auditor. One school of thought believes that auditors will lose their independence if they are too closely involved in the development and implementation of new IT systems. The supporters of this school also believe that it is not cost-effective to use auditors if the system is not yet operational.

The other school of thought believes that the auditors are experts in internal control and that they should share their expertise and knowledge with the entity in the implementation of the new IT system and the related controls. They believe that it is too costly to "fix" the system afterwards and that recommendations for improvements should be taken into account when implementing the system. When the auditors are extensively involved in the process, they themselves become a general control in the reliability of the system.

Generally it is best for the internal and external auditors to be involved in the process as long as safeguards (controls put in place to limit independence threats, for



example the audit team involved in the implementation may not be involved in the year-end audit) are put into place by the auditors.



### Notes

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Read through the Global Technology Audit Guide (GTAG) 3 – Managing and Auditing IT vulnerabilities. <https://na.theiia.org/standards-guidance/recommended-guidance/practice-guides/Pages/Practice-Guides.aspx>

## STUDY UNIT 5.6: AUDITING SECURITY AND PRIVACY OF INFORMATION ASSETS



### 5.6.1 INTRODUCTION

Information security may be defined as security around and within the computer environment and associated equipment as well as security associated with the people using it. Information security includes issues such as access management and the protection of the personal information of customers and staff members.

## 5.6.2 INFORMATION SYSTEMS SECURITY

Information security is all about protecting and preserving organisational information and information relating to customers and staff members.

The information security standard BS7799-1:1991 defines **information security (IS)** as follows:

- **Confidentiality:** ensuring that information is accessible only to those authorised to have access
- **Integrity:** safeguarding the accuracy and completeness of information and processing methods
- **Availability:** ensuring that authorised users have access to information and associated assets where required

Information security is more than making your network and internet services secure; it involves authenticating employees, customers, remote offices, suppliers and partners. Hardware, software and firmware coexist and an auditor cannot examine one aspect in isolation. It is the interaction of these components that provides complexity and an auditor should look on access control as a complex exercise in risk management technology. The hardware, software and firmware of the company also need to be protected against unauthorised use or even abuse by staff members.

Information security is the responsibility of all employees of an organisation from management downwards. Management's security concerns focus on the effects of a breakdown in security rather than the technical implementation of a security system. Information system security has become very complex because of distributed IT environments. IT environments involve a multitude of servers, databases and desktops and have multiple users. However, organisations must be aware that identity and access management (IAM) programs frequently collect personal information about system users and this can be a breach of the privacy and data protection laws. The auditor should give assurance that any IAM programs are aligned with the necessary laws and regulations, such as the Electronic and Communications Act in South Africa.

There are various control techniques that can be applied to address the risk in relation to information security. Management should start with a proper risk assessment (risk management process) regarding information security to determine where the biggest challenges are and decide on a plan of action on how to address any weaknesses in a cost-efficient manner.

Some of the tools and techniques (controls) available to manage risks are the following:

- information security policy
- identity and access management (IAM)
- encryption



### 5.6.3 INFORMATION SYSTEM SECURITY POLICY

An information security policy expresses a general commitment, direction or intention by management regarding the safeguarding of information assets. The policy covers the **hardware**, **software** and **information** found in the IT environment. All stakeholders, including management and the users of information technology in a company, must realise that information security is not an add-on to the IT environment but an essential part and that it should be seen as a component of a high quality system.

These questions need to be answered when auditing the information security policy:

1. Are there policies in place for managing and administering user identities and access activities?
2. Is there a strategy in place for addressing the risks associated with the IAM process?

3. Is there a reference model the organisation can use during the administration process?

When the auditor evaluates the answers to these questions it is important to determine whether documentation already exists that addresses these issues to some degree. The business's existing policies and procedures should support the workflow and the information system environment. However, it is necessary to have a specific policy in place regarding information security.

The **five pillars** of any security policy are the following:

- **Authentication.** Users must be identifiable before they gain access to the system.
- **Authorisation.** The user must have the necessary authority to get access to the system and the authority to use specific programmes and software within the system. Furthermore, the user must have the necessary authority to get access to specific information.
- **Integrity.** The integrity of the information and the performance of the system should be protected. Users must be confident that processing will take place effectively and efficiently and that the results will be reliable.
- **Confidentiality.** Users should know that access to certain programs and information is a privilege and they should be able to be trusted to use the information only for business purposes.
- **Nonrepudiation.** There must be an audit trail so that the system can prove that the person who accessed as the user was actually the person doing the work on the system.



Discuss what an information security policy involves and the detail that should be included in the policy.



The information security policy should provide the fundamental guidelines used in assessing the value of the information assets and the impact should an untoward event occur.

The following information should be included:

- Information is an important asset of the organisation and must be protected as such.
- By protecting information assets, the organisation will comply with all applicable laws and regulations and will ensure that its employees do so as well.
- Access to information will be granted to individuals when required for the performance of their business functions.
- Confidentiality of information will be maintained.
- Information must be appropriately protected against unauthorised modification.
- Information will be available as and when required to support the authorised and the judgement business functions of the organisation.
- The appropriate control structures must be implemented to ensure the integrity, confidentiality and availability of information.



- What are the most important elements of the information system security policy that an auditor should be aware of?



#### 5.6.4 ENCRYPTION AND OTHER INFORMATION SECURITY TOOLS AND CONTROL TECHNIQUES

##### Controlling access to computer resources

To control access to all computer resources, including hardware, software and information, there must be proper identity and access management systems in place. These will now be discussed.

##### Identity and access management

The system of controls is a complex system comprising various **policies, procedures, activities** and **technologies** to address the security risks. It is necessary to involve different departments, such as the IT department and human resources, to put a proper internal control system in place.

The important questions to be addressed while implementing such a system are the following:

1. **Who has access to what information?** A decision needs to be taken as to who should have access to which resources, applications and information.
2. **Is the access appropriate for the job being performed?** Is the job description supported by the access given and is access given to a person which could be in conflict with and threaten the segregation of duties principle?
3. **Are the access and activity monitored, logged and reported appropriately?** The system should be designed in a way that supports

regulatory compliance in the different environments. It should also facilitate the auditing process by logging all access so that it can be traced to ensure that only legitimate users have accessed the system.

Identity and access management is based on the following principles:

- **Identity:** the element or combination of elements used to uniquely describe a person or equipment.
- **Access:** the information representing the rights that the identity was granted. These information access rights can be granted to allow users to perform transactional functions at various levels.
- **Access rights or entitlements:** the collection of access rights to perform transactional functions.

For identities to become part of the identity and access management system there are three stages that need to be followed, namely:

- **Provisioning.** Request, validate, approve, propagate and communicate the process. This should be in line with the security policy.
- **Identity management.** Monitor and manage passwords, audit and reconcile, administer policies and strategise or manage systems.
- **Enforce:** authenticate, authorise and log activities.

## Encryption

Data that are communicated between two computers or other devices should be secured against eavesdropping or even manipulation. One way to ensure the security of data is to use encryption and in South Africa the Electronic Communications and Transactions Act (ECT Act) 25 of 2002 must be adhered to regarding specific communication protocol and infrastructure.

According to Cascarino (2007:302), cryptography is the name given to the use of mathematical algorithms to transform data. Its primary use is the protection of information and it is a fundamental tool used in underpinning many aspects of

computer security, including data confidentiality, data integrity, user authentication and electronic signatures. Encryption is a technique for turning messages into unreadable codes by scrambling up the data in such a way that the legitimate recipient can unscramble or “decrypt” the message easily, but an unauthorised recipient would only see garbage.

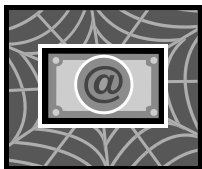
In the ECT Act 25 of 2002, chapters 4, 5 and 11, there are specific provisions relating to cryptography providers and encryption standards that a business should take note of.

The auditor needs to test the following:

- That secure socket layer (SSL) communication protocol is used to secure sensitive information as it makes use of a two-key encryption standard.
- That public key infrastructure (PKI) is utilised in conjunction with SSL.

The act can be accessed at the following website:

[http://www.acts.co.za/ect\\_act/index.htm](http://www.acts.co.za/ect_act/index.htm)



## 5.6.5 THE AUDITOR AND INTERNET

Although you have probably encountered concepts such as the *information highway*, or *cyberspace*, some of you may not yet know what the internet really consists of and what an advantage it can be to auditors.

### Gaining access to the internet

To gain access to the internet, you require the following:

- a personal computer
- a telephone line
- a modem for connecting the personal computer to the telephone line
- the necessary software



- an internet connection

The most usual way of getting connected to the internet is by means of:

- a direct connection or
- an intel connection by telephone line from a remote place to an internet service provider

### **Direct connection to the internet**

A direct connection to the internet is usually available through big organisations which are linked to the internet for business reasons. A direct connection with the internet is effected by means of a rented line which is allocated to a particular user.

The following factors should be borne in mind when a direct connection with the internet is being considered:

- This type of connection is relatively expensive but it does provide a rapid and reliable connection to the internet.
- It offers a full range of internet services such as electronic mail, file transfer and access to the world wide web.
- A large number of users in the organisation can gain access to the internet.
- The management of the organisation can exercise control over access to the internet.
- A direct connection requires specialised knowledge and skills for installation and maintenance.

## **Intel connection to an internet service supplier**

An intel connection is obtained by phoning an internet service provider (ISP) that is linked to your computer by means of a modem.

The following factors should be borne in mind when considering an intel connection with the internet:

- The type of modem required for linking your computer to the internet by telephone line through the agency of your service provider.
- The software required for access to the internet through your service provider. The software is usually supplied by your service provider.
- The internet services you require.
- This service is usually slower than a direct internet connection.
- The geographical location of your point of access to the internet since this determines the call charge for your telephone call.

## **Internet services which are of special use to auditors**

The internet is a valuable source of information for auditors and may be used in research, problem-solving or communicating with clients or other auditors.

The following internet services are very important to auditors and are discussed in greater detail below:

- ✓ electronic mail (e-mail)
- ✓ downloading files (FTP)
- ✓ world wide web (WWW)



### **Electronic mail (e-mail)**

Electronic mail is the most basic internet services and is also its most widely used. E-mail enables you to communicate by way of your computer with any other person anywhere in the world if that person has an e-mail address. An e-mail address is normally your log-in code on your local network.

Apart from sending information to or receiving information from other people connected to the internet, e-mail also enables the auditor to subscribe to mailing lists or discussion groups on the internet. The discussion groups bring auditors with particular interests or particular problems together electronically.

### **File transfer protocol (FTP)**

The file transfer protocol of the internet enables the auditor to download and upload computer files on other computers connected to the internet. Access for FTP purposes to other computers on the internet is controlled by the organisation from which you want to download or to which you want to upload files. Most organisations require you to be a registered user but there are some that allow nonregistered users to access their computer systems. The FTP function of the internet enables auditors, for example, to exchange audit programmes and other files electronically. In order to download files from a remote computer you must know the unique IP address of the computer as well as the location and name of the particular file you want to download on that computer.

The FTP address is normally written in the following format: *ftp://* plus the unique site name, the location of the file (the directory) and the name of the particular file. The *ftp://* (*file transfer protocol*) is the generally accepted way of identifying sites offering file transfer facilities.



## World Wide Web (WWW)

The WWW on the internet is based on hypertext technology which ensures easy access to information on the internet. Hypertext technology is also able to handle graphic and sound files. In order to use the WWW you need a browser such as Netscape or Internet Explorer. In order to visit a particular site on the WWW you need to know the address or URL (uniform resource locator) of the computer in question. The following is an example of the format in which this address is normally written: <http://www.unisa.ac.za/>. The *http* (*hypertext transfer protocol*) is the generally accepted method of identifying computers on the WWW. The part of the URL that follows the letters *http://* is the unique name of the computer where the information is situated.

### Risks associated with an internet connection

In spite of the cost efficiency and business advantages, there are significant risks which are associated with an internet connection. These risks can be grouped into the following six main areas:

- **Masquerade:** A normal attack where a user imitates somebody by using that person's login name and password in order to obtain additional privileges.
- **Disclosure:** It is quite simple for someone to wire tap into a communication transmitted via the internet, including e-mail files and passwords.
- **Unauthorised access:** Despite programmers' attempts, some internet software packages still contain vulnerable areas which make their systems vulnerable to attacks. On top of this, many of these systems are large,

causing difficulties in their configuration and resulting in a large percentage of incidents of unauthorised access.

- **Loss of data integrity:** One of the threats which is commonly overlooked is the modification of data while on a computer or in transit. The simple addition of the word “not” in a document, or the addition of several zeros at the end of an amount, is enough reason to cause chaos in the electronic trade.
- **Refusal of service:** Refusal of service occurs when an internet network is flooded with data and/or requests which have to be serviced. This can cause the computer to stop functioning and be unavailable for any other purpose.
- **Theft of services and resources:** Theft of services is a huge threat for those enterprises which offer special services to specific clients via the internet.



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 7:

- Implications of IT for internal auditors.
  - IT proficiency and due professional care
  - Assurance engagement IT responsibilities
- Sources of IT audit guidance.



**Notes**

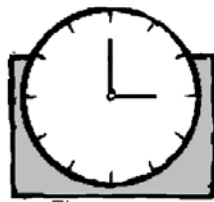
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**TOPIC SUMMARY**

A computer information systems environment exists when a computer of any kind or size is used in the processing of an entity’s financial or other information. The use of computers may have an influence on the accounting and internal control systems.

We introduced the concept of computer risks and exposures and include the development of an understanding of the major types of risk faced in the information system function.

The actual internal controls introduced in organisations in order to attain the internal control objectives can be related to certain generally applicable control activities. In order to be able to evaluate internal controls and make recommendations on possible weaknesses and suggest improvements to internal control systems, IT auditors require a thorough knowledge of control activities and the related internal control measures.

This topic introduced you to the concept of computer assisted audit techniques. The advantages and disadvantages of using computer assisted audit techniques were also discussed. The factors which auditors should take into consideration if they intend to use CAATS in carrying out the audit process were discussed in this topic. Attention was also given to the factors that are important in implementing CAATS.

The scope of computer security is virtually all-embracing and covers just about everything that could go wrong. In this study unit we discussed the IS security policy. The principles of information security and controlling access to computer resources and encryption were explained.

The internet is a steadily growing combination of networks which is used by millions of people all over the world for a variety of purposes. In the auditing field both external and internal auditors are making increasing use of the internet in the execution of their duties. Internet literacy has therefore become extremely important to auditors.

## TOPIC 6: VARIOUS CONSULTING ENGAGEMENTS

### INTRODUCTION AND PURPOSE OF THE TOPIC

In this study unit we briefly reflect on the definition of the internal audit activity. We also discuss the difference between assurance and consulting services and consider the various elements of a consulting engagement.



### LEARNING OUTCOMES

**After you have studied this topic, you should be able to:**

- define the internal audit activity
- explain the difference between consulting and assurance activities
- discuss the different types of consulting services
- describe the consulting engagement process

### CONTENT OF THE TOPIC

Internal audit functions are in a prime position to increase the value they add to the organisation by expanding the number of consulting services they provide.

In this topic we discuss the definition of the internal audit activity and the difference between assurance and consulting engagements. The main focus is on the various elements of consulting services and the consulting engagement process.

Study unit	Title
6.1	Introduction to consulting services
6.2	The consulting engagement process



## STUDY UNIT 6.1: INTRODUCTION TO CONSULTING SERVICES



### 6.1.1 INTRODUCTION

In this study unit we briefly look at the definition of the internal auditing activity and then at the difference between consulting and assurance engagements and the different types of consulting service.



### 6.1.2 THE DIFFERENCE BETWEEN ASSURANCE AND CONSULTING SERVICES



#### 6.1.2.1 Definition of the internal auditing activity

By now you should be familiar with the definition of the internal audit activity. Let's reflect for a moment on the definition of the internal audit activity.



The definition of the internal audit activity, as approved by the International Institute of Internal auditors, reads 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.*

The main objective of internal auditing is determined by the needs of the board of directors and management of an organisation so as to assist them in improving the governance, risk management and control processes and the effective discharge of their responsibilities. The internal auditor must ensure that these needs are addressed in the internal audit report that should be issued after each audit engagement.

This can be achieved through the following:

- an interpretation of factual circumstances and events in the organisation that have been exposed by the internal auditor's examination (**reactive evaluation – assurance service**)
- constructive and cost-effective suggestions to identify risks and to eliminate problems and/or to improve the efficiency and effectiveness of the organisation's governance, risk management and control processes (**proactive evaluation – consulting service**)



#### *6.1.2.2 The difference between assurance and consulting services*

### **Assurance services**

The IIA defines **assurance** services as follows:

*An objective examination of evidence for the purpose of providing an independent assessment on governance, risk management and control processes for the organisation. Examples may include financial, performance, compliance, system security and due diligence engagements.*

Examples:

- the assessment that management's policies and procedures are adhered to
- examining whether control procedures are mitigating the risks identified

In terms of **standard 2120** on risk management and assurance services:

**2120.A1** – The internal audit activity must evaluate risk exposures relating to the organisation's governance, operations and information systems regarding the:

- ✓ Reliability and integrity of financial and operational information.
- ✓ Effectiveness and efficiency of operations and programs.
- ✓ Safeguarding of assets and
- ✓ Compliance with laws, regulations, policies, procedures and contracts.

**2120.A2** – The internal audit activity must evaluate the potential for the occurrence of fraud and how the organisation manages fraud risk.

### **Consulting services**

The IIA defines **consulting** services as follows:

*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 organisation's governance, risk management and control processes without the internal auditor assuming management responsibility. Examples include counsel, advice, facilitation and training.*

Examples:

- conducting control self-assessment training
- providing advice to management on risk management, control and governance issues
- assisting in developing and drafting policies

In terms of **standard 2120** on risk management and consulting services:

**2120.C1** – During consulting engagements, internal auditors must address risk consistent with the engagement's objectives and be alert to the existence of other significant risks.

**2120.C2** – Internal auditors must incorporate knowledge of risks gained from consulting engagements into their evaluation of the organisation's risk management processes.

**2120.C3** – When assisting management in establishing or improving risk management processes, internal auditors must refrain from assuming any management responsibility by actually managing risks.



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 15:

- The difference between assurance and consulting services

- Engagement parties
- Applications of standards
- Engagement purpose
- Engagement communication

*Internal auditing: assurance & consulting services, chapter 2:*

- Assurance and consulting services



What are the differences between an assurance engagement and a consulting engagement?



To answer this question you need to provide the definition of both assurance and consulting services. You should therefore ensure that you can explain the difference between assurance and consulting services.



Ensure that you work through exhibit 12-2 in your textbook – examples of internal audit assurance and consulting engagements.



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services, chapter 12:*

- The consulting engagement process.



### 6.1.2.3 Types of consulting service

Consulting services comprise a wide range of activities based on management's needs. The specific consulting engagements that an internal audit function can perform are limited only by the needs of the organisation and the resources of the function provided they do not impair the independence of the internal audit function or the objectivity of the internal auditors.

Types of consulting service:

- advisory consulting engagements
- training consulting engagements
- facilitative consulting engagements
- blended engagements



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 15:

- Types of consulting service
  - Advisory consulting engagements
  - Training consulting engagements
  - Facilitative consulting engagements
  - Blended engagements



### 6.1.2.4 Selecting consulting engagements to perform

Consulting engagements are selected based on the magnitude of the associated risk or opportunity.

Sources of consulting engagements:

- annual internal audit plan
- requests from management

- new or changing conditions

Regardless of the how consulting engagements are identified, they are typically put through the internal audit function's risk assessment process to determine whether the risk warrants the expenditure of scarce internal audit resources.



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 15:

- Selecting consulting engagements to perform
  - Annual internal audit plan
  - Requests from management
  - New or changing conditions
  - Risk assessing potential consulting engagements



- Ensure that you can identify and discuss the different types of consulting engagement the internal audit activity can perform.
- Ensure that you can explain how the internal audit function chooses which consulting engagement to perform.



## Notes

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## STUDY UNIT 6.2: THE CONSULTING ENGAGEMENT PROCESS

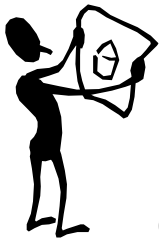


### 6.2.1 INTRODUCTION

The internal audit function is uniquely positioned to add value and make an impact on the organisation when performing consulting engagements. Consulting services provided by the internal audit function can be very valuable to the organisation.

Consulting services provide many opportunities for internal auditors to increase their knowledge and skills in areas that may not be part of the assurance engagement environment.

In this study unit we discuss the consulting engagement process, consulting working papers and the changing landscape of consulting services.



### 6.2.2 THE CONSULTING ENGAGEMENT PROCESS

Given that consulting engagements can differ so greatly in nature and scope, the process for conducting them also varies from engagement to engagement.



You should carefully study the following outline of a consulting engagement:

- Planning the advisory consulting engagement
  - Determine engagement objectives and scope.

- Obtain final approval of objectives and scope from consulting engagement customer.
- Understand the engagement environment and relevant business processes.
- Understand relevant risks, if appropriate.
- Understand relevant controls, if appropriate.
- Evaluate control design, if appropriate.
- Determine engagement approach.
- Allocate resources to the engagement.
- Performing the advisory consulting engagement
  - Gather and evaluate evidence.
  - Formulate advice.
- Communicating and follow up
  - Determine nature and form of communications with engagement.
  - Give advice to engagement customer.
  - Conduct interim and preliminary engagement communications.
  - Develop final engagement communications.
  - Distribute final engagement communications.
  - Perform monitoring and follow up if appropriate.



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 15:

- The consulting engagement process
  - Planning the advisory consulting engagement
  - Performing the advisory consulting engagement
  - Communication and follow-up





### **6.2.3 CONSULTING ENGAGEMENT WORKING PAPERS**



Study the following section in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 15:

- Consulting engagement working papers



### **6.2.4 THE CHANGING LANDSCAPE OF CONSULTING SERVICES**



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 15:

- The changing landscape of consulting services
- Capabilities needed
  - Skills and experience required
  - Sourcing



Read through the Practice Guide – Auditing executive compensation and benefits  
<https://na.theiia.org/standards-guidance/recommended-guidance/practice-guides/Pages/Auditing-Executive-Compensation-and-Benefits-Practice-Guide.aspx>

Read through the Practice Guide – Auditing external business relationships  
<https://na.theiia.org/standards-guidance/recommended-guidance/practice-guides/Pages/Auditing-External-Business-Relationships-Practice-Guide.aspx>



- ✓ Explain the skills that are required of an internal auditor when performing consulting engagements.
- ✓ Explain the importance of creating and maintaining working papers for a consulting engagement.



#### Notes

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In this topic we briefly reflected on the definition of internal audit. The difference between assurance and consulting services was discussed and you should be able to differentiate between these services. After working through this study unit you should now be able to explain how you would go about selecting a consulting engagement.

By committing to the training of internal auditors and adhering to the guidance provided in the standards, the internal audit function can maintain its independence

and internal auditors can maintain their objectivity while delivering high-quality consulting services to their organisation.

We dealt with the differences between assurance and consulting services, the different types of consulting engagement, the consulting engagement process as well as the changing landscape of consulting services.

# **PART D: REPORTING AND FOLLOW-UP ON THE COMPLETION OF AUDIT ASSIGNMENT**

## **TOPIC 7: REPORTING AND FOLLOW-UP ON THE COMPLETION OF AUDIT ASSIGNMENT**



### **INTRODUCTION AND PURPOSE OF THE TOPIC**

The results of an internal audit assignment are communicated to all interested parties in the audit report. The principal purpose of the internal audit report is to bring useful and timely information on deficiencies to the attention of management and recommend improvements. In this study unit we introduce you to the general reporting principles.



### **LEARNING OUTCOMES**

**After you have studied this topic, you should be able to:**

- identify the aim and principles of internal audit reporting
- produce good internal audit reports
- communicate information through presentations
- evaluate the follow-up on audit results

### **CONTENT OF THE TOPIC**

In this topic we discuss the authoritative requirements pertaining to reporting and

follow-up. We also cover writing internal audit reports, presenting internal audit reports and follow-up on completed projects.

Study unit	Title
7.1	Reporting on completed audit assignments
7.2	Presenting internal audit reports
7.3	Follow-up on completed audit assignments

## STUDY UNIT 7.1: REPORTING ON COMPLETED AUDIT ASSIGNMENTS

### 7.1.1 INTRODUCTION

Reporting is one of the internal auditor's biggest headaches, particularly as far as achieving balanced reporting and reporting at the appropriate level are concerned.

In this study unit we discuss how to write an internal audit report, the principles and analysis of audit findings and how to finalise the audit report.



### 7.1.2 WRITING INTERNAL AUDIT REPORTS



#### *7.1.2.1 Aim and principles of internal audit reporting*

The internal auditor should give an overall opinion and then report the findings in detail. The internal auditor will determine that a manager is either

- meeting the standard or
- not meeting the standard

If the internal auditor decides that a manager is meeting the standard, he will indicate this in his overall opinion. The internal auditor should summarise his conclusions on the relevant working paper to be used as input in forming the overall audit opinion. It is unlikely that the internal auditor will want to report each standard that the manager is meeting, as this will make reporting cumbersome and less effective readers do not

want to see a list of all the things the manager is doing right, but they do want a summary of them and also information about corrective action where the manager is not doing things right.

However, there may be circumstances in which the internal auditor wants to report on the standards with which managers are complying. For example, an internal auditor may have previously found major problems in a department but on revisiting the department, finds that the manager has corrected the problems. In this case, the internal auditor may wish to report that the corrective action has been taken. This creates good relations between the internal auditor and departmental managers. But, more importantly, it gives top managers feedback indicating that the departmental manager has taken corrective action and that she is now managing her department more effectively.

In the reporting phase of an internal audit, the audit team communicates the results of the audit to interested employees in management and on the staff. The basic objectives of internal audit reports are:

- to supply useful and timely information on operational deficiencies and other aspects and
- to suggest improvements in the way in which the organisation is run

The internal audit report is the audit team's opportunity to get management's undivided attention. The internal audit report therefore serves a twofold purpose, namely

- to communicate the results of an internal audit
- to persuade and call for action

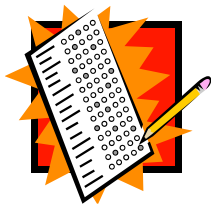
If the audit has been correctly carried out, the audit findings will already have been discussed with interested members of staff and management and efforts will already have been made to rectify deficiencies in the system. The final internal audit report is basically merely a summary of the completed audit, documenting the following:

- (1) what the internal audit team has achieved
- (2) what was found in the course of the audit
- (3) the extent of the deficiencies in the auditee organisation
- (4) the steps taken by the personnel to rectify the situation

In cases where internal 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.

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



#### *7.1.2.2 IPPF requirements for reporting on completed audit*

##### *assignments*

An effective audit report ensures that the reader understands all the important information in the shortest possible time. This objective will be realised only if the arrangement and presentation of the report meet all the requirements of sound communication. The report should first inform the person to whom it is directed about the subject of the audit and go on to give the findings and any audit opinion and recommendations which require the attention of someone at that level of management. .

The audit report must be objective, clear, concise, constructive and timely. Each of these elements is an important principle of communication, and must therefore be understood and applied as such. All of these elements are relative and cannot be determined or measured precisely, except for the elements of objectivity and timeliness, which are to some extent measurable. It is therefore vital for the internal auditor to acquire the skills necessary to apply them effectively and efficiently in any form of communication, but especially when producing written reports.



Study the following:

- International Professional Practice Framework (IPPF)

<b>Standards</b>	
2400	Communicating results
2410, 2410.A1, 2410.A2	Criteria for communicating
2420	Quality of communications
2421	Errors and omissions
2430	Use of “Conducted in conformance with the International Standards for the Professional Practice of Internal Auditing”
2440, 2440.A1	Disseminating results
2500	Monitoring progress
2600	Resolution of Senior Management’s Acceptance of Risks
<b>Practice Advisories</b>	
2410-1	Communication criteria
2420-1	Quality of communications
2440-1	Disseminating results
2440-2	Communicating sensitive information within and outside the chain of command



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 14:

- Additional assurance engagement communication standards
- Quality of communications
- Errors and omissions





### 7.1.2.3 The principles of the analysis and interpretation of audit

#### *findings*

#### **The need for findings**

Findings can arise from any phase of the audit. They are fundamental to the auditing process. Findings provide managers with feedback on their performance and with corrective action to rectify problems. If the internal auditor has discovered areas where improvement is needed, and has agreed corrective action, managers will be able to correct the problem and improve unit performance. It is vital that the internal auditor develops findings that lead to managers taking corrective action.

Internal auditors often do not adequately develop their findings and therefore do not maximise their contribution to organisational performance. One reason internal auditors fail is that they neglect to analyse the findings in sufficient detail to convince the manager of the need for corrective action. Unless managers are convinced of the need to take corrective action, they will not. An excellent audit cannot be effective unless corrective action is taken where risks are identified.

#### **Favourable and unfavourable findings**

Findings can be favourable or unfavourable. Favourable findings are on activities that the manager is doing right. The internal auditor wants to report them to the manager, but they do not require corrective action. Unfavourable findings are activities the manager is doing wrong. They require corrective action and must be reported.



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 14:

- Perform observation evaluation and escalation process
  - COSO category
  - Classification

- Impact and likelihood of the observations
- Insignificant
- Significant
- Material



## **Elements of an audit finding**

Internal audit findings may be positive or negative. All audit findings consist of at least two components, namely the criteria or standards that should be achieved and the true state of affairs. Negative findings have three additional components, namely the cause, effect and recommendations for rectifying the situation. The role of the various elements of audit findings may be summed up as follows:

### *Statement of condition*

Fact-gathering forms part of every audit project. Facts that constitute part of the state of affairs should be accurate, properly supported, and clearly and precisely defined. Every fact should be so thoroughly supported by working papers that its accuracy cannot be questioned. This is the who, what, where and how element, that is:

- What was found?
- What was observed?
- What is not functioning effectively or efficiently and what is defective?
- Is the condition isolated or widespread?

### *Criteria/standards*

The internal auditor's choice of criteria or standards for assessing existing conditions requires experience and wisdom. The reasonableness of audit findings depends on the choice of the correct criteria or standards for assessing the performance of the organisation and applying those criteria or standards correctly. It is the responsibility of the internal auditors to persuade interested parties that the criteria they are using are reasonable. This element is a comparison of the ideal with the actual, that is:

- What should the position be?
- What is the standard of comparison?
- What is the standard procedure or standard practice?
- Is it a formal or an informal procedure?

### *Cause*

Recommendations generally arise directly from the cause, and it is therefore desirable to present the cause and the audit recommendations together in the audit report. Constructive recommendations depend largely on identifying the cause accurately. If the auditors know why a certain event took place it is easier to prevent recurrence in future. This element involves an investigation into the factors that give rise to the problem that has been identified, namely:

- Why did it happen?
- What was the underlying cause of the deviation?
- What caused the activities to become inefficient and uneconomic?

### *Effect*

The effect section of the audit finding quantifies the impact of the deficiencies and encourages management to take corrective action. The materiality of a deficiency is judged by its effect. This element is an analysis of the present and potential impact of a finding on operations.

- What is the significance?
- What is the consequence of the finding?
- What will the final result be if the condition continues?

### *Recommendations*

It is important that the users of the audit report should know exactly why a particular audit recommendation has been made, in other words what do the auditors intend to rectify and what benefits would be achieved from the implementation of the recommendations. The most important point is that anyone affected by the recommendations should agree on the benefits of the proposed changes so that they can be motivated to implement the proposals. Because many people experience change negatively, it is important to discuss all proposals with the interested parties before the final report is issued to make certain that they agree to the proposals and are prepared to implement them. This element involves a consideration of the steps that could be taken to improve or rectify the existing situation, such as:

- What could be done to rectify the situation?
- What recommendations are practicable and reasonably acceptable?
- Who should implement the recommendations?



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 14:

- Perform observation evaluation and escalation process
  - Engagement observations and recommendations
  - Criteria
  - Condition
  - Cause
  - Effect
  - Detailed recommendation



The following statements were taken from internal audit findings and are not necessarily related. Opposite each statement, indicate what element of an audit finding that statement represents, using the following code: A = description of the condition, B = criterion/standard, C = cause, D = effect or E = recommendation.

1. The actual project costs at 31 December 2014 were R16 685,00, which amounted to more than 10% of total project costs.
2. The above situation was due to the fact that the person in charge of the assets did not exercise proper control over the receipt of the equipment.
3. In addition, there were no procedures in place for monitoring the activities of employees.
4. The required ledger control accounts should be created and kept up to date in order to ensure control over funds.
5. We are of the opinion that the practice of keeping duplicate records also contributed to the unnecessarily high labour and costs.
6. According to a recommendation by the Commissioner of Inland Revenue,

personal computers should be depreciated over three years.

7. We were informed that there was only a verbal agreement between the departmental manager and the provider of the service.
8. In our opinion it is essential for the proper management and control over funds that local offices should submit timely and accurate reports on their final expenditure figures.
9. As a result the administrative costs of the department were overstated by an amount of R258 784,00, according to our calculations.
10. The approval of projects is one of the most important responsibilities of the board of directors and we believe that management should take all possible measures to ensure that the information submitted to them is accurate and reliable.

**Source:** Based on Reider, HR. 1995. *Complete guide to operational auditing*.



Feedback on the above statements:

- (1) A & B
- (2) C
- (3) C
- (4) E
- (5) D
- (6) B
- (7) A
- (8) B
- (9) D
- (10) B & E



As part of the internal audit of the purchasing department of XYZ, the auditors examined the procedures followed by the person responsible for the administration

and control of company cars in the organisation. It is common practice in the business sector in question to lease vehicles and allocate them to members of staff in cases where the lease costs are less than the allowance paid to the employee for official trips at the prevailing tariff. Analyses that were carried out have shown that 24 of the 87 leased vehicles were issued to employees who use them to cover short distances every day. It was also found that 37 members of staff use their own private motor vehicles for official trips on a regular basis and claim an allowance of R1,20 per kilometre, and that the allowance paid to them monthly amounts to more than the cost of leasing a vehicle. A schedule was drawn up by the auditors to analyse the optimum allocation of company vehicles within the organisation. An evaluation of the entire situation, taking into account the recommendations with regard to the allocation of vehicles, showed that potential savings would amount to a minimum of R50 000,00 per year.

### **Required**

Develop a complete audit finding on the basis of the information provided above.

**Source:** Based on Reider, HR. 1995. *Complete guide to operational auditing*.



#### *Description of the condition*

Our analysis of the use of fleet vehicles by your staff for the year ended 30 June 20XX indicated the following:

- a. Of the 87 vehicles in the vehicle fleet, 24 vehicles are not used sufficiently to justify their cost. It would be more economic for the organisation to allow those employees to use their own vehicles and then remunerate them for the kilometres covered at the present rate of R1,20 per kilometre.
- b. On the other hand there are 37 employees who make so much use of their own vehicles for official trips that the remuneration they receive annually at R1,20 per kilometre exceeds the cost of leasing a vehicle and allocating it to them permanently.

#### *Criteria*

In this business sector it is general practice to lease vehicles and allocate them to personnel in cases where the lease costs are lower than the allowance that would be paid to the employee for official trips at the prevailing tariff.

*Cause*

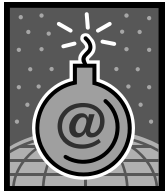
At present there is no procedure for analysing the utilisation of company vehicles and private vehicle allowances for official purposes for a specific period. As a result the present state of affairs has developed over a number of years.

*Effect*

The present situation has resulted in losses to the organisation of over R50 000,00 per year.

*Recommendation*

We recommend that the organisation should implement a procedure for monitoring the utilisation of company vehicles and private vehicles on a continuous basis. The present state of affairs should be rectified by revising the allocation of company vehicles in accordance with the attached schedule, which would lead to an annual saving of at least R50 000, 00.

**Discussion of the findings with management**

If the operational audit is successful, many of the recommendations made by the audit team will be implemented as the audit project progresses. Findings should be discussed with management throughout the audit. This ensures that attention will be given to the auditor's findings right from the beginning of the audit and it will not be necessary to repeat everything in the final operational audit report.

The final operational audit report may eventually contain no more than a summary of findings and management's response to them. Management's response may be either to agree with the findings and introduce changes or to gather more information on the recommendations and reach a decision on implementation or to disagree with the findings and accordingly not to implement the recommendations.

*Agreeing corrective action*

The first step in developing corrective action is to confirm the internal auditor's objective, the manager's objective and the actual performance (quality of control or quality of performance). Where the manager's objectives (at the required level of performance) and the actual performance are below the required performance, the internal auditor should develop a deficiency finding and agree with the manager on corrective action.

Actual performance which exceeds required performance may require corrective action, depending on the reasons for the exceeding of required performance. The internal auditor should discuss and agree all deficiency findings with the responsible managers. Once this has been done, the recommendations made and the causes identified will form the base on which managers can agree on corrective action.

#### *Agreed corrective action*

In theory, properly developed recommended corrective action supported by appropriate information should sell itself. However, in practice, even where the finding is supported by information and the recommended corrective action is logical and reasonable, the manager may not agree to implement it.

Once the internal auditor has developed recommended corrective actions, he should discuss them with the appropriate manager. During this discussion, the internal auditor should discuss the manager's objective, his actual performance, the impact and the cause. The internal auditor should not wait to discuss findings: they should be dealt with while they are still fresh in the internal auditor's mind. He should also emphasise that the agreed action will be reported, thereby acknowledging the manager's participation in the process. The manager should agree on the objective, substandard performance and the cause and impact. If the manager disputes these, the internal auditor should show the manager the supporting information. The manager may produce new information. If so, the internal auditor should consider this new information and decide if it changes his evaluation of the manager's performance, or his recommended corrective action. Once the facts are agreed on with the manager the internal auditor should discuss the effect of the finding and get his agreement.

Only then can the internal auditor discuss the recommended corrective action. The internal auditor should make it clear that the action to be carried out is the manager's responsibility. The internal auditor should therefore encourage the unit manager to suggest courses of action, always respecting his opinions. For example, implementation of the internal auditor's recommendation may be impractical because of unforeseen considerations. The internal auditor's objective is to get agreement on action that will address the cause and reduce the potential impact to an acceptable level. If the manager comes up with a course of action that meets these requirements, the internal auditor should agree. No matter how good his recommendation, if the manager's action addresses the substandard performance, the internal auditor cannot insist that his recommendation be followed.

The agreement should cover the three parts of the recommended action: what action, by when and by whom. This commits the manager to the agreed action, and is used by the internal auditor in deciding when to follow up.



*No agreement on action*

Even if the impact is well researched, the cause is thoroughly analysed and understood and the recommended corrective action is based on the cause, it is still possible that the manager will not agree to the recommended corrective actions. There may be many reasons for this. For example, a manager, despite being involved in the participatory process, may still fear his boss's response when the report hits his desk.

The internal auditor should not change his original recommended corrective action as long as his information is sound or unless the unit manager provides other information that requires the internal auditor to re-evaluate his recommended corrective action. Where deadlock is reached, the internal auditor should record both his recommended corrective action and the manager's comments on why he refuses to take corrective action. The internal auditor may wish to take the matter up with the manager's manager. If agreement is still not reached, both the internal auditor's and the managers' viewpoints should be reported. They can then be discussed at a higher level. Top managers must then decide either to force the unit manager to take corrective action or to accept the risk that arises from not implementing the internal auditor's recommended corrective action.

Once the findings are discussed and agreed on, the internal auditor can put these into his report. The effect of the findings will determine how they are reported. High impact findings should usually be reported separately. Medium impact findings are reported in the body of the report. Low impact findings are usually reported verbally and not be included in the written report.

In reporting findings, the standard, the condition, the effect, the cause and the agreed action should be reported. The rules relating to reporting apply. The parts should be reported in the manner that best gets the message across to the recipient. The different parts can appear in any order, but should be in the same order within the same report.

The internal auditor should not report the recommended corrective action. Why? Because although it is part of the process of reaching agreed action, it is the agreed action that is important, not the internal auditor's recommendation. This makes the report more objective and management focused.

Only where agreement cannot be reached, should both the recommendation and the manager's response be reported. The manager's response should clearly state the reason for the disagreement.



#### 7.1.2.4 Drafting an audit report

An audit can be considered successful only after an effective and efficient audit report has been issued. In the first place an effective audit report must reflect the achievement of the objectives of the particular internal audit task. Secondly, the presentation of the audit report must conform to generally accepted principles of communication, as discussed in section 7.1.2.2. These factors constitute the points of departure for a discussion of the content and presentation of an audit report based on a specific audit task.



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 14:

- Conduct interim and preliminary engagement communications



The basic characteristics of good internal audit reporting are the following:

- Only important matters should be reported.
- Internal audit reports should be useful and timely.
- Internal audit reports should be accurate and should be adequately supported by vouchers.
- The findings should prompt the management and personnel involved to take action.
- Audit reports should be objective and should contain sufficient information to give their readers the necessary perspective.
- Internal audit reports should be clearly and simply presented.
- Internal audit reports should be concise.

- Internal audit reports should have a constructive impact.
- Internal audit reports should be logically arranged and positive.

### **The format of internal audit reports**

There is no generally accepted or prescribed format for internal audit reports. Nevertheless standard formats for audit reports are used in internal audit departments.

A format that is flexible and comprehensive and can be used for any internal audit report that is not longer than four typed pages is the following:

- management summary (if applicable)
- background
- overview
- opinion/general evaluation
- findings, recommendations and conclusions
- comments by the auditee

As soon as the report exceeds four pages, the auditor is required to draw up an executive summary of the report and attach it.



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 14:

- Engagement communication obligations
- Develop final engagement communications
  - Rating systems



You are a senior internal auditor at a large manufacturing organisation and your audit team has just completed the annual audit of the purchasing department. You have assigned one of the junior members of the audit team to prepare the draft internal audit report for the audit.

The following draft report is presented to you for approval:

## **Audit of the purchasing department**

### *Introduction*

The purchasing department is solely responsible for all acquisitions, except those requiring executive approval.

During the past months, 10 110 purchase orders, to the value of R2 157 000, were issued for all kinds of products.

The audit covered only 5 of the 12 product classifications for which purchasing was done.

### *Purpose and scope*

The audit was performed to determine whether

- competitive bidding was employed
- purchase orders were being approved at an appropriate level
- the buyers performed the required follow-up procedures

### *Findings and opinion*

1. New acquisition procedures require a control system in which supervision is used to ascertain that all the approved suppliers have the opportunity to bid.
2. We found that 57 purchase orders, each exceeding R12 000, had been approved by the buyer only. We reported this finding.
3. Follow-up action on purchases that were received late indicated that the problem still exists.
4. Based on a sample of 200 items, the error rate in the purchase orders issued should not exceed 2%.

**Required**

Evaluate the draft report and, where necessary, recommend improvements, using the internal auditing standards relating to reporting as a basis for your evaluation.



Weaknesses and suggested improvements to the report

Weaknesses in the report	Improvements suggested
The date of the report is not stated.	The report should have a date.
The report is not properly addressed.	The report should be addressed to the relevant interested parties.
“...except those requiring executive approval.”	Criteria for requiring executive approval must be explained.
“During the past months...”	The exact date of the audit must be noted.
The scope of the audit is vaguely outlined in the introduction.	Explain how the scope was determined or why it was limited to 5 out of 12 products. (If necessary, related activities not audited should be identified to delineate the boundaries of the audit.)
The purpose of audit is not clear.	The purpose should describe the audit objectives and may, where necessary, inform the reader why the audit was conducted and what the expected results were. State that the purpose of the audit was to determine whether the buyers had initiated follow-up procedures when orders were not received on time.
Findings and opinion	Findings should be based on criteria, conditions, cause and effect and opinions – that is the conclusion – should follow the findings in an orderly and logical way.
Does not respond to original stated audit objectives	Add a comment that competitive bids have always been obtained in the past.
Does not indicate the procedures followed to arrive at the findings.	Criteria must be stated – what should exist. All orders exceeding R12 000 must be approved by the head of purchasing; also out of 200 items

	examined we found..
Does not clearly substantiate findings or explain significance of findings.	Audit findings emerge by a process of comparing what should be with what is. Relate the sample to the total population and then base all the findings on <ul style="list-style-type: none"> <li>- what should exist</li> <li>- what does exist</li> <li>- why there is a difference</li> <li>- the impact of the difference</li> </ul>
There is no indication of the sample method, error rate or confidence level used.	The report should include the sample method, error rate and confidence level used. (The nature and extent of the auditing performed should be described in the scope.)
Does not explain the significance of the findings on late shipments.	Explain the risk or exposure because of the late shipments.
The report does not include positive remarks on procedures and controls that may be operating effectively.	Constructive reports help the auditee and the organisation and lead to improvement where necessary. (Reports may acknowledge satisfactory performance and corrective action.)
The report is not signed.	Only a signed audit report may be issued.



### Notes

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## STUDY UNIT 7.2: PRESENTING INTERNAL AUDIT REPORTS



### 7.2.1 INTRODUCTION

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

In this study unit we discuss the reasons for presenting, the presenting process and using visual aids.



### 7.2.2 THE REASONS FOR PRESENTING

By getting a clear understanding of the purpose of the presentation, the internal auditor has a better chance of achieving the main objective. There are many reasons for communicating information in the form of a presentation:

- **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 is an opportunity to check how effectively the information is understood.

- **Communicating an urgency and immediacy to the subject**

The spoken word is very persuasive when used effectively. In addition, nonverbal cues and the form of the presentation allow the internal auditor to 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 points that may be unclear in the report. This is due to some managers providing insufficient or late feedback on the internal auditor's report. It is also often difficult for the internal auditor to convey all pertinent information gathered in an audit to the manager. Presentations on the other hand give the internal auditor the opportunity to clarify her findings and opinion based on the manager's reactions. The internal auditor who is sensitive to these reactions and adapts her positions accordingly, is more likely to reach 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 internal auditors 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 give managers a good idea of his 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 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.





### 7.2.3 THE PRESENTING PROCESS

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.

While planning the presentation it is advisable to obtain the input of an internal auditor who has experience in presenting. She 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. 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 good time, fully and thoroughly, and for success. Sixty percent of the effort should go into the planning stage.

To prepare effectively, the internal auditor needs to find a place and time where there will be no interruption. She should have the information needed close at hand and 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 is to be communicated
- what action the internal auditor wants the recipient to take

It takes a great deal of planning and good presentation skills to maintain the involvement, interest and attention of the managers during a presentation. Many presentations lack direction due to poor planning and presenting. The internal auditor must think about why she is presenting, what she wants to achieve and her target audience. 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?
- Is there any possibility 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. It is therefore important to decide on 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 are already favourable 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. It is not only for presenting 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 relates to 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 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).

### **Structuring the outline**

If the outline is sufficiently detailed, it should provide sufficient information for key point notes and overheads.

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 the presentation is management-oriented.
- It helps the internal auditor to present his findings and opinion logically.
- It enables the managers to follow easily.
- It provides a framework to fall back on if the discussion moves away from the original purpose.

The information should be structured clearly and logically. Managers are normally more receptive at the beginning of the presentation. The internal auditor should therefore put the most important message first. The other items can 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



### 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 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 overcome their distraction and gain their attention, the internal auditor should choose a technique most appropriate to the subject and obtain 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.

### 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 can be up to five main points but 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 all managers have the same understanding, it should be presented 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, she should use examples, statistics, expert testimony, illustrations and demonstrations.

### 3. *The conclusion*

This is where the presentation should produce results: it is what the internal auditor wants 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.

### **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 report writing, the most important guideline is for the internal auditor to put herself in the position of the audience for the presentation. Although the structure of a report is important, the structure of a presentation is arguably 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.

In editing, she should consider the following questions:

- Have I considered 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 she ignores possible objections, her presentation may fail.

### **Planning the venue and equipment**

An unfavourable environment can detract from the quality of a presentation. The internal auditor should consider the following before the presentation:

- booking of the venue and equipment
- ensuring the presentation room will be adequate, ie tables, chairs, lighting and airconditioning
- ensuring 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 how the various equipment works beforehand



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 14:

- Distribute formal and informal communications
  - Formal
  - Informal



### **7.2.4 USING VISUAL AIDS**

#### **Using visual aids**

Smell, touch and taste account for a mere 6%, sound for 11%, and sight for 83% 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 herself props to talk from. These also act as reminders or prompts 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 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 can be used:

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

### **Making the presentation**

Before making the actual presentation it is advisable to have a dry-run for some fellow internal auditors.

Body language plays a key role in the impact of the presentation: 93% of a message is nonverbal and only 7% is verbal. Of the 93%:

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

### **Verbal communication**

The internal auditor should choose her words carefully. She should use, where applicable, short, simple words. Managers are not impressed by someone who, through the language she uses, tries to show how educated she is and thus 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
- speak slowly
- stress main points

- speak with confidence
- vary speaking pace and tone of voice
- use deliberate pauses discreetly



**Don't:**

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

### **Nonverbal communication**

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

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

### **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 manager is trying to read the aid
- never divide the attention of the managers
- 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 slide

No matter what visual aids the internal auditor uses, she is still the primary focus of attention. 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.



The chief internal auditor wants to market the internal auditing department, and especially operational auditing, in his organisation. He therefore encourages the audit managers to put in some effort when personally presenting their audit findings and audit reports.

### Required

Indicate why it is important for the internal auditor to structure a personal presentation properly.



### Reasons for properly structuring personal presentations

1. It reduces anxiety as the internal auditor knows what he or she is going to be said next and where key points are going to be stressed.
2. It ensures that the presentation is management oriented.
3. It helps the internal auditor to present his or her findings and opinions logically.
4. It enables the auditee managers to follow the presentation easily.
5. It provides a framework to fall back on if the discussion moves away from the original purpose.



### Notes

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## STUDY UNIT 7.3:FOLLOW-UP ON COMPLETED AUDIT ASSIGNMENTS



### 7.3.1 INTRODUCTION

In this study unit we briefly discuss the importance of following up on audit results and monitoring the audit recommendations.



### 7.3.2 FOLLOWING UP ON AUDIT RESULTS

The internal auditing process is not complete before all the procedural modifications have been introduced. Organisational policy should require that written commentary on every internal audit report be submitted to the chief audit executive by the people to whom the audit report was addressed. The following should be specified in a company's policy:

- the format in which feedback should be produced
- how much time should be allowed for a response to internal audit reports
- who is responsible for drawing up and signing comments on internal audit reports

The chief audit executive should receive copies of all comments on audit reports and should pass on any reservations on such feedback to top management.

Irrespective of whether the internal auditors have checked the comments on their audit reports and accepted them, they should still carry out the necessary follow-up action to determine whether any corrective measures have been taken and whether they are satisfactory.

Management may decide to take different steps to rectify a problem from the steps suggested by the auditors. The decision rests with management, but the results of

the decision should still be weighed up by the internal auditors. If management does implement the steps proposed by the auditors, the auditors should still follow up in order to evaluate the results achieved. If the audit findings showed up material problems, it may be necessary to schedule a full follow-up audit to make certain that the desired results have been achieved by the implementation of the audit recommendations.



Study the following:

International Professional Practice Framework (IPPF)

- Standards 2500, 2500.A1, 2500.C1 and 2600
- Practice Advisories 2500-1 and 2500.A1-1



### 7.3.3 FOLLOW UP AND MONITOR THE AUDIT

#### RECOMMENDATIONS

The reporting process, and thus the entire audit process, is not complete until the auditee's reaction to the report has been gauged. The audit process will essentially be a futile exercise if the audit findings do not receive the necessary attention.

Follow-up and monitoring can be managed by dividing the recommendations into different categories for follow-up, depending on the importance and urgency of the implementation of the recommendations.

Consider the policies and procedures in place in the organisation that apply for the specific auditee before you decide on how and when to perform follow-up procedures. These policies and procedures could impact on the timing and extent of the follow-up procedures. The normal controls process should apply when the follow-up process finds that the recommended improvements do not properly resolve the identified problem by allowing the management of the auditee the opportunity to amend the improvements until the problem is in fact sorted out.



Study the following sections in your prescribed textbook:

*Internal auditing: assurance & consulting services*, chapter 14:

- Perform monitoring and follow-up



### **Additional reading**

Practice Guide – formulating and expressing internal audit opinions.

<https://na.theiia.org/standards-guidance/recommended-guidance/practice-guides/Pages/Formulating-and-Expressing-Internal-Audit-Opinions-Practice-Guide.aspx>



### **Notes**

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In this topic we dealt with the formulation of internal audit findings. Specific attention was paid to the five elements of audit findings, their practical application, and the development of recommendations and the submission of findings to management.

We also discussed the reporting stage of the internal auditing process and we showed that this stage is an extension of the other stages of the internal audit process. We briefly discussed the aim and functions of the operational audit report,

it characteristics, a proposed format for operational audit reports, and the follow-up of audit results.

The internal auditor's responsibility to follow up on the reported issues and to monitor any improvement prompted by the report was discussed.