CIA Part 2
Practice of Internal Auditing

Part 2, Domain I
Managing the Internal Audit Activity

Section A: Internal Audit Operations

Learning Outcomes:

1. Describe policies and procedures for the planning, organizing, directing, and monitoring of internal audit operations. Basic Level.
2. Interpret administrative activities (budgeting, resourcing, recruiting, staffing, etc.) of the internal audit activity. Basic Level.

Managing the Internal Audit Function

A. According to the Standards, the chief audit executive must effectively manage the internal audit activity to ensure it adds value to the organization. The internal audit activity is effectively managed when:
   1. It achieves the purpose and responsibility included in the internal audit charter.
   2. It conforms to the Standards.
   3. Its individual members conform to the Code of Ethics and the Standards.
   4. It considers trends and emerging issues that could impact the organization.

B. Managing the internal audit activity involves overseeing its day-to-day operations, including the following administrative activities:
   1. Formulating policies and procedures for the planning, organizing, directing, and monitoring of internal audit operations.
   2. Budgeting and human resource administration, including recruiting, staffing, personnel evaluations and compensation.

C. **Internal Audit Policies and Procedures** – The Standards state that the CAE must establish policies and procedures to guide the internal audit activity. Therefore, the CAE or head of internal audit is responsible to formulate policies and procedures for the planning, organizing, directing, and monitoring of internal audit operations. Guidance on internal audit policies and procedures is provided in implementation guide 2040 – Policies and Procedures, which is summarized below.

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1. The form and content of the policies and procedures are dependent upon the size and structure of the internal audit activity and the complexity of its work. While a large, mature internal audit activity may have a formal internal audit operations' manual that includes the policies and procedures, a smaller or less mature internal audit activity may not. Instead, policies and procedures may be published as separate documents.
2. It is essential to ensure that internal audit policies and procedures are aligned with:
    a. The Mandatory Guidance of the International Professional Practices Framework (IPPF).
    b. The internal audit charter.
    c. The organization's strategies, policies, and processes.
3. The following topics are generally included in an internal audit manual or otherwise documented to help guide the internal audit activity:
    a. Internal audit policies:
        i. The overall purpose and responsibilities of the internal audit activity.
        ii. Adherence to the Mandatory Guidance of the IPPF.
        iii. Independence and objectivity.
        iv. Ethics.
        v. Protecting confidential information.
        vi. Record retention.
    b. Internal audit procedures:
        i. Preparing a risk-based audit plan.
        ii. Planning an audit and preparing the engagement work program.
        iii. Performing audit engagements.
        iv. Documenting audit engagements.
        v. Communicating results/reporting.
        vi. Monitoring and follow-up processes.
    c. Quality assurance and improvement program.
    d. Administrative matters.
        i. Training and certification opportunities.
        ii. Continuing education requirements.
        iii. Performance evaluations.
4. To ensure internal audit personnel are properly informed about internal audit policies and procedures, the CAE may issue individual documents, training materials, or a comprehensive manual; and training sessions may be conducted to review the information.
5. Internal audit policies and procedures should be reviewed periodically. Such reviews may be included in the internal audit activity's internal assessments and the external assessment.

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D. Budgeting and Resources Management

1. According to the Standards, the CAE must ensure that internal audit resources are appropriate, sufficient, and effectively deployed to achieve the approved plan.
   a. **Appropriate** refers to the mix of knowledge, skills, and other competencies needed to perform the plan.
   b. **Sufficient** refers to the quantity of resources needed to accomplish the plan.
   c. **Effectively deploying resources** means that the resources are used in a way that optimizes the achievement of the approved plan.
2. Ensuring the adequacy of internal audit resources is ultimately a responsibility of the organization's senior management and the board; the CAE should assist them in discharging this responsibility. The CAE is primarily responsible for the **sufficiency and management** of internal audit resources in a manner that ensures the fulfillment of internal audit's responsibilities, as detailed in the charter. This includes determining:
   a. Financial budgets.
   b. Number of auditors required and staffing plans.
   c. Knowledge, skills, and other competencies required from auditors to complete their work.
3. The CAE communicates to senior management and the board the internal audit activity's resource requirements including resources for employees, external service providers, financial support, and technology-based audit techniques.
4. From an overall resource management standpoint, the CAE:
   a. Develops the operating and financial budget for internal audit operations. The budget should be developed annually and then submitted to management and the board for their review and approval.
   b. Conducts a periodic skills' assessment or inventory to determine the specific skills required to perform the internal audit activities.
   c. Ensures that resources are deployed effectively.
   d. Considers succession planning, staff evaluation and development programs, and other human resource disciplines.
   e. Develops appropriate metrics, goals, and objectives to monitor the overall adequacy of resources.
5. To select and develop the human resources of the internal audit activity the CAE should establish a program that provides for:
   a. Developing written job descriptions for each level of the audit staff.
   b. Selecting qualified and competent individuals.
   c. Training and providing continuing educational opportunities for each internal auditor.

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d. Appraising each internal auditor's performance at least annually.

e. Providing counsel to internal auditors on their performance and professional development.

Passing Tip:	Internal audit activity resources must be adequate and sufficient to meet the audit plan requirements.

6. When faced with limited resources (both financial and/or human resources), the least desirable option for completing future engagements would be to eliminate certain engagements from the work-schedule. The following options may be attempted:

   a. Using self-assessment questionnaires to address audit objectives.

   b. Employing information technology whenever possible.

   c. Filling any human resource vacancies with personnel from operating departments that are not being audited (considering potential impairments to independence and objectivity).

7. Any resource limitations or other related factors that might affect the scope of engagements or the engagement work schedule must be promptly reported to senior management and the board.

8. **Interview Candidates for Internal Audit Positions** – The CAE is ultimately responsible to interview candidates for internal audit positions. While this task may be delegated in larger internal audit functions, ultimate responsibility for recruitment rests with the CAE. A need for internal auditors usually arises from the function's plans, and resource requirements. When interviewing candidates for internal audit positions, several attributes are preferred in potential candidates:

   a. Education and background – internal auditors are preferred to have as much background information as possible. Certification is a significant plus for potential candidates.

   b. Experience – the required experience for internal auditors depends on the position within the internal audit function, and the types of engagements that the internal audit function is expected to perform. Generally, the CAE ultimately matches the required experience to the position.

   c. References and background checks – it's crucial to obtain references and background checks of any potential candidates to be employed in sensitive positions. Internal auditing is considered a sensitive position since they will be in privity to a wide array of documents and information, and thus the CAE must obtain contact references and obtain background information to ensure the integrity of potential candidates.

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d. No impairment to independence and objectivity – internal auditors must be independent and must carry out their duties with objectivity, and thus, upon interviewing potential candidates, the CAE must ensure that no actual or potential conflicts of interest or impairments to independence exist.

e. Technical skills – some internal audit functions require specialized skills, and thus if this is the case, the CAE must ensure that applicants possess the required technical skills. For example, if the internal audit department conducts operational and compliance audits of a nuclear plant, it is essential that any auditor have the related technical skills.

f. Know when to seek help – internal audit candidates may not necessarily possess the extensive technical skills, but they must be able to realize when they need help. They should be able to determine when they require help and how to seek it. It may be by researching technical literature or consulting with industry experts.

g. Other preferred personal attributes of candidates for internal audit positions:

   i. Ability to summarize responses in a clear and concise manner.
   ii. Ability to structure communication in sufficient detail, yet straight to the point.
   iii. For supervisory positions, ability to communicate constructive feedback.
   iv. Ability to meet deadlines, work under pressure, and time management.
   v. Achieve a proper work-life balance.
   vi. Attention to details and the prompt ability to identify red flags.
   vii. Analytical skills.
   viii. Interpersonal skills with auditees.
   ix. Teamwork both as team players and as team leaders for supervisory positions.
   x. Self-motivated and high initiative.

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Section B: Establish Risk-Based Internal Audit Plan

Learning Outcomes:

1. Identify sources of potential engagements (audit universe, audit cycle requirements, management requests, regulatory mandates, relevant market and industry trends, emerging issues, etc.). Basic Level.
2. Identify a risk management framework to assess risks and prioritize audit engagements based on the results of a risk assessment. Basic Level.
3. Interpret the types of assurance engagements (risk and control assessments, audits of third parties and contract compliance, security and privacy, performance and quality audits, key performance indicators, operational audits, financial and regulatory compliance audits). Proficiency Level.
4. Interpret the types of consulting engagements (training, system design, system development, due diligence, privacy, benchmarking, internal control assessment, process mapping, etc.) designed to provide advice and insight. Proficiency Level.
5. Describe coordination of internal audit efforts with the external auditor, regulatory oversight bodies, and other internal assurance functions, and potential reliance on other assurance providers. Basic Level.

Internal Audit Plan

A. **Three Levels of Planning** – Generally, planning is a continuous process throughout the internal audit activity's operations and over several time spans. The types of plans may be combined into less or more levels depending on the organization and nature of engagement, but generally, there are three basic levels of planning:

   1. **Internal audit plan** – for each period, an internal audit plan is developed that covers the planned audits of the internal audit activity during the period. This plan would be the result of the risk assessment of the entire organization. The plan would detail what engagements are planned to be performed during the period.
   2. **Engagement Plan** – for each engagement, the internal auditor develops an audit plan which is based on a detailed risk assessment of the engagement area and identifies the engagement objectives (Discussed in Domain-II of Part-2).
   3. **Engagement Work Program** – lists detailed procedures that should be conducted by the auditor to achieve specific audit objectives that will achieve the engagement objectives (Discussed in Domain-II of Part-2).

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B. According to the Standards, the CAE must establish a risk-based plan to determine the priorities of the internal audit activity, consistent with the organization's goals.

   1. To develop the risk-based plan, the chief audit executive consults with senior management and the board and obtains an understanding of the organization's strategies, key business objectives, associated risks, and risk management processes. The chief audit executive must review and adjust the plan, as necessary, in response to changes in the organization's business, risks, operations, programs, systems, and controls.

C. The internal audit plan usually includes:

   1. A list of proposed audit engagements (and specification regarding whether the engagements are assurance or consulting in nature).
   2. Rationale for selecting each proposed engagement (e.g., risk rating, time since last audit, change in management, etc.).
   3. Objectives and scope of each proposed engagement.
   4. A list of initiatives or projects that result from the internal audit strategy but may not be directly related to an audit engagement.

D. When developing the internal audit plan, the CAE should coordinate with other assurance providers.

   1. The CAE considers the internal audit activity's ability to rely on the work of other internal and external assurance providers to ensure proper coverage and minimize duplication of efforts.
   2. Coordination and discussions with other assurance providers may highlight new areas of significance that might require internal audit attention, resulting in new potential engagements.

E. Although audit plans typically are prepared annually, they may be developed according to another cycle. For example, the internal audit activity may maintain a rolling 12-month audit plan and reevaluate projects on a quarterly basis. Or, the internal audit activity may develop a multi-year audit plan and assess the plan annually.

F. Planning for the internal audit activity must be consistent with its charter and with the goals of the organization. The planning process involves establishing goals for the internal audit activity and developing engagement work schedules and budgets.

   1. **The goals of the internal audit activity** must be capable of being accomplished within specified operating plans and budgets and, to the extent possible, should be measurable. They should be accompanied by measurement criteria and targeted dates of accomplishment.
   2. **Engagement work schedules and budgets** normally include the following:
      a. What activities are to be performed,
      b. When they will be performed (the commencement date), and

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c. The estimated time required, taking into account the scope of the engagement work planned and the nature and extent of related work performed by others.

d. Measurability criteria.

e. Staffing requirements and time allocation.

f. Detailed expense budget.

G. The internal audit plan is intended to ensure that internal audit coverage adequately examines areas with the greatest exposure to the key risks that could affect the organization's ability to achieve its objectives. Planning for the internal audit activity involves the following steps which will be discussed separately:

1. Determining all potential engagements.
2. Prioritizing engagements based on risk assessment.
3. Identifying resource requirements.
4. Communicating the plan for review and approval.

Determining Potential Engagements

The first step in internal audit planning is to determine all potential engagements within the scope of internal audit. The sources of potential engagements include:

A. **Audit Universe** – is a list of all possible audits that could be performed within an organization. Defining the audit universe requires reviewing the number of auditable entities in terms of both the business units or areas of operations within the organization and the number of auditable units or activities within and across those business units.

1. The audit universe includes audit projects and initiatives related to the organization's strategic plan, and it may be organized by business units, product or service lines, processes, programs, systems, or controls.
2. Some examples of auditable activities include:
   a. Policies, procedures, and practices both on an organization level and those specific to areas or locations.
   b. Information system security.
   c. Information system infrastructure.
   d. Major contracts or product lines.
   e. Functions such as manufacturing, distribution, purchasing, accounting, finance, marketing and other functions.
3. It is advisable to assess the audit universe (and related audit plan) on at least an annual basis to reflect changes in the organization's strategy, management direction, objectives, emphasis and focus. In some situations, audit plans may need to be updated more frequently (e.g., quarterly) in response to changes in the organization's business, operations, programs, systems, and controls.

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B. **Market, Product, and Industry Knowledge** – Internal auditors use market, product, and industry knowledge to identify new internal audit engagement opportunities. Any information available to internal auditors may be utilized to identify new engagement opportunities. Examples include:

   1. During a period of intense and/or fierce competition, internal auditors may wish to conduct an operational audit to ensure both the effectiveness and efficiency of operations. Such an audit may focus on potential cost reductions, and/or seek to eliminate inefficiencies in the process.
   2. New trends in an industry may reflect directly on operations, and create a potential for new internal audit engagements, such as the fragmentation of an industry, competition from other industries, regulation over the industry by the government or other authority, introduction of new laws impacting the industry . . . etc.
   3. An internal auditor learns of product features that may not be in compliance with existing laws and regulations, and/or industry standards, and thus a compliance audit may be required.
   4. New environmental standards are to be implemented that may affect the product or the production process, and thus, a potential environmental audit and/or product audit may be required.

C. **Management Requests** – When developing the plan, the CAE considers requests by senior management, the audit committee, or the governing body as they may require the internal audit activity to conduct specific engagements.

D. **Regulatory Mandates** – regulatory agencies may impose new regulations on the organization that may require the organization to conduct certain audits or demonstrate compliance with certain regulations. The CAE considers these mandates when determining potential engagements and developing the plan.

E. **Organization's Strategic Plan and Risk Exposures** – In identifying the potential engagements and preparing the internal audit plan, the CAE starts by consulting with senior management and the board to understand the organization's strategies, business objectives, risks, and risk management processes.

   1. The audit universe (potential engagements) can include components from the organization's strategic plan. By incorporating components of the organization's strategic plan, the audit universe will consider and reflect the overall business objectives. The organization's strategic plan considers the environment in which the organization operates. These same environmental factors would likely impact the audit universe and assessment of relative risk.
   2. The internal audit activity's plan is designed based on an assessment of risk and exposures that may affect the organization's ability to achieve its strategic objectives. Ultimately, the audit objective is to provide management with information to mitigate the negative consequences associated with accomplishing the organization's objectives.

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3. The audit universe can be influenced by the results of the risk management process. When developing audit plans the outcomes of the risk management process should be considered. Thus, the audit universe and audit plan preparation usually involves reviewing the results of any risk assessments that management may have performed. In addition, the CAE considers the maturity of the organization's risk management processes, including whether the organization uses a formal risk management framework to assess, document, and manage risk.
4. To ensure that the audit universe covers all of the organization's key risks, the internal audit activity typically independently reviews and corroborates the key risks that were identified by senior management.

Prioritizing Engagements Based on Risk Assessment

A. The internal audit plan is intended to ensure that internal audit coverage adequately examines areas with the greatest exposure to the key risks that could affect the organization's ability to achieve its objectives. Therefore, the audit plan is based on, among other factors, an assessment of risk priority and exposure. Prioritizing is needed to make decisions for applying relative resources based on the significance of risk and exposure.

B. **Definitions**

1. **Risk** is the probability that an event or action may adversely affect the organization or activity under audit. Risk is usually measured by the potential dollar or materiality of adverse exposure to the organization.
2. **Risk Identification** is the process of identifying all risks that affect the organization objectives. All imaginable risks that may affect the success of the organization must be identified, ranging from the more significant business risks down to the less important risks related to individual projects or smaller business units
3. **Risk Assessment** is a systematic process for assessing and integrating professional judgments about probable adverse conditions and/or events. The risk assessment process should provide a means of organizing and integrating professional judgments for development of the audit plan.

C. According to the Standards, the internal audit activity's plan of engagements must be based on a documented risk assessment, undertaken at least annually. The input of senior management and the board must be considered in this process.

D. The internal audit activity needs to establish a risk-assessment framework for identifying potential engagements, prioritizing them, and selecting the risk priorities to be included in the annual audit plan. The risk-assessment framework employs various quantitative and qualitative methods to determine risk weightings.

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E. The best risk assessment technique is usually a comprehensive approach to risk management taking into consideration, the causes, the event, and the impact. This would be achieved by assessing risk levels of current and future events, their effect on achievement of the organizational objectives, and their underlying causes.

F. Linking critical risks to specific objectives and business processes helps the CAE organize the audit universe and prioritize the risks. The CAE uses a risk-factor approach to consider both internal and external risks.

   1. **Internal risks** may affect key products and services, personnel, and systems. Relevant risk factors related to internal risks include the degree of change in risk since the area was last audited, the quality of controls, and other factors.

   2. **External risks** may be related to competition, suppliers, or other industry issues. Relevant risk factors for external risks may include pending regulatory or legal changes and other political and economic factors.

G. The CAE should ensure that the schedule of audit priorities is revised and updated in accordance with the most recent risk assessment and prioritization of the risks. In addition, the CAE should maintain an ongoing dialogue with senior management and the board to stay abreast of changes that may affect risk assessments and affect current audit priorities.

H. A variety of risk models exist to assist the chief audit executive in prioritizing potential audit subject areas. Most risk models utilize risk factors to establish the priority of engagements such as:

   - Dollar materiality
   - Asset liquidity
   - Management competence
   - Quality of internal controls
   - Degree of change or stability
   - Time of last audit engagement
   - Complexity
   - Employee and government relations, etc.

   1. Other methods that may be used to prioritize risks may involve a matrix involving a risk reduction factor, a cost savings factor, and the extent of changes since last engagement. The auditor would typically have to assign weights to the aforementioned factors and give priority to the audits with the highest total weights.
   2. The expertise of available audit staff is considered least important when prioritizing engagements since audit needs rather than auditor skills should determine the priorities in the risk-based plans.
   3. Changes in management direction, objectives, emphasis, and focus are normally reflected in updates to the audit universe and related audit plan.
   4. In conducting audit engagements, methods and techniques for testing and validating exposures need to be reflective of the risk materiality and likelihood of occurrence.

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Passing Tip:

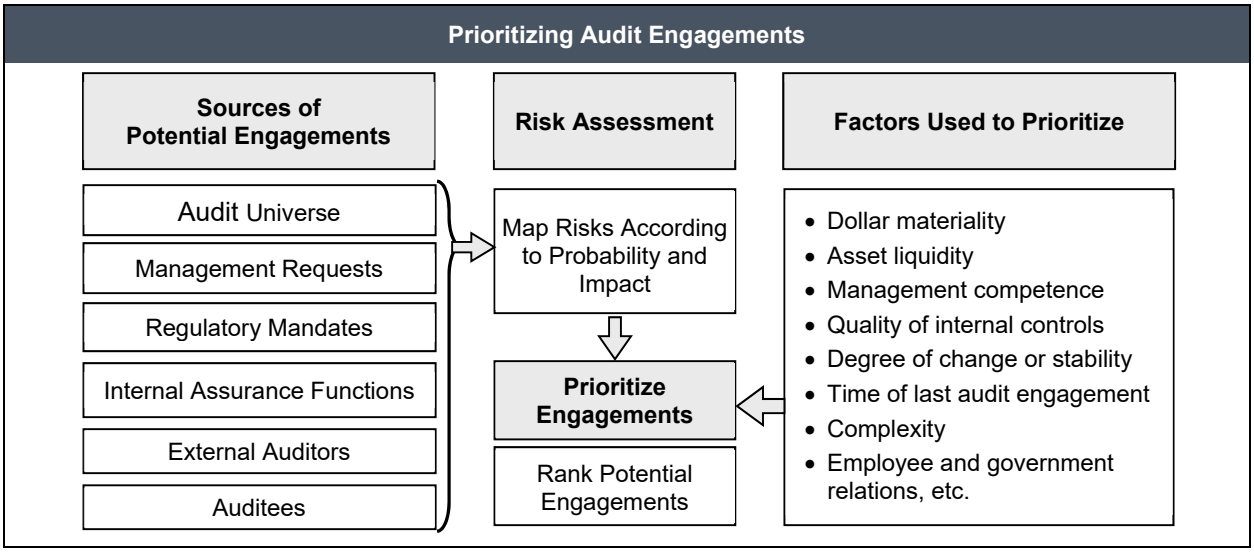
The following is the prioritizing of risks when internal audit resources are limited. Likely risks are given first priority before possible risks (regardless of criticality), and risks with remote likelihood have least priority.

		Likelihood		
		Likely	Possible	Remote
Impact	Critical	1	4	7
	Major	2	5	8
	Minor	3	6	9

Further, when there is a possibility of fraud, it would normally receive higher attention than an area that has not been previously audited or requests of external auditors.

I. Matters to be considered in establishing engagement priorities include:
   1. The dates and results of the last engagement.
   2. Updated assessments of risks and effectiveness of risk management and control processes.
   3. Requests by senior management, the audit committee, and the governing body.
   4. Current issues relating to organizational governance.
   5. Major changes in the enterprise's business, operations, programs, systems, and controls.
   6. Opportunities to achieve operating benefits.

J. The CAE should consider accepting proposed consulting engagements based on the engagement's potential to improve management of risks, add value, and improve the organization's operations. Those engagements that have been accepted must be included in the plan.



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Passing Tip: The rationale for using risk assessment for audit planning is because it provides a systematic process for assessing and integrating professional judgment about probable adverse conditions.

Illustration of Prioritizing Audit Engagements

For example, an auditor is evaluating 5 engagements based on the following three factors:

1. The engagement's potential to reduce risk to the organization.
2. The engagement's potential to save money to the organization.
3. The extent of change in the related area since the last engagement.

The auditor typically assesses the above three factors to each engagement and associates each factor with a High, Moderate, or Low assessment. Based on the auditor's judgment, the matrix would look like this:

Audit	Risk Reduction	Cost Savings	Changes
1	High	Moderate	Low
2	High	Low	Low
3	Low	High	Moderate
4	Moderate	Moderate	High
5	High	Moderate	High

Next, the auditor would typically assign a weight to each factor when assigning score points. The weight for all three factors may be equal or more emphasis is placed on one factor than the others.

The auditor may normally assign points as follows (or using any other objective criteria):

Assessment	Points
High	3
Moderate	2
Low	1

If all factors are weighted equally, the audit priorities become as follows:

Audit	Risk Reduction	Cost Savings	Changes	Total Score	Audit Priority
1	High (3)	Moderate (2)	Low (1)	6	3
2	High (3)	Low (1)	Low (1)	5	4
3	Low (1)	High (3)	Moderate (2)	6	3
4	Moderate (2)	Moderate (2)	High (3)	7	2
5	High (3)	Moderate (2)	High (3)	8	1

If the Risk Reduction factor and the Cost Savings factor are considered twice as important as the changes, the audit priorities become as follows:

Audit	Risk Reduction	Cost Savings	Changes	Total Score	Audit Priority
1	High (6)	Moderate (4)	Low (1)	11	2
2	High (6)	Low (2)	Low (1)	9	4
3	Low (2)	High (6)	Moderate (2)	10	3
4	Moderate (4)	Moderate (4)	High (3)	11	2
5	High (6)	Moderate (4)	High (3)	13	1

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Identifying Resource Requirements

A. As indicated earlier, the CAE must ensure that internal audit resources are **appropriate**, **sufficient**, and **effectively deployed** to achieve the approved plan.
   1. **Appropriate** refers to the mix of knowledge, skills, and other competencies needed to perform the plan.
   2. **Sufficient** refers to the quantity of resources needed to accomplish the plan.
   3. **Resources are effectively deployed** when they are used in a way that optimizes the achievement of the approved plan.

B. After developing the internal audit plan, the CAE determines the resources needed to accomplish the plan, based on the risk-based priorities identified during the planning process. Resources may include:
   1. People – work hours and skills.
   2. Technology – audit tools and techniques.
   3. Timing – availability of resources.
   4. Funding.

C. For determining the needed resources, the CAE usually begins by gaining a deeper understanding of the resources available to the internal audit activity.
   1. The CAE considers the number of internal audit staff and productive work hours available to implement the plan within the organization's schedule constraints.
   2. The CAE reviews a documented skills assessment or gather information from employees' performance appraisals and post-audit surveys to gain an overview of the internal audit activity's collective knowledge, skills, and other competencies
   3. The CAE reviews the approved budget and consider the funds available for training, technology, or additional staffing in order to achieve the plan.

D. The CAE then compares the resources needed to accomplish the plan's priorities with those available to the internal audit activity to determine whether any gaps exist. This comparison can be used as a basis for determining the impact of resource limitations.

E. To fill gaps related to the internal audit staff's knowledge, skills, and competencies, the CAE could provide training for existing staff, request an expert from within the organization to serve as a guest auditor, hire additional staff, or hire an external service provider.

F. Any resource limitations (both financial or human resources) that might affect the scope of the audit plan must be promptly reported to Senior Management and the Board.

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Types of Engagement – Assurance Engagements

Assurance services involve the internal auditor's objective assessment of evidence to provide opinions or conclusions regarding an entity, operation, function, process, system, or other subject matters.

According to the IIA Glossary, assurance service is an objective examination of evidence for the purpose of providing an independent assessment on governance, risk management, and control processes for the organization. Examples may include financial, performance, compliance, system security, and due diligence engagements.

The different types of assurance engagements are discussed in the following sections.

A. **Risk and Control Self-Assessment**

1. **Control Self-Assessment (CSA)**, or risk and control self-assessment, is the process of assessing the effectiveness of the organization's risk management and internal control system. All employees participate in the process that is mainly aimed at ensuring effective and efficient achievement of the organizational goals. Using the CSA method, everyone in the organization becomes the process owner.
2. CSA can be used by management or the internal audit activity as an audit technique. In a CSA, internal auditors work with local team members in an area of the organization, leading them in an effort to evaluate their current control procedures and then to use the review results to improve internal controls.
3. CSA enhances the system of internal control in a procedural manner as follows:
    a. Identifying potential risks and assessing related controls.
    b. Establishing satisfactory controls in terms of effectiveness and cost-effectiveness.
    c. Emphasizing management's responsibility for the internal control system.
    d. Communicating results.
4. The primary advantages of CSA include
    a. Indicates the degree of the functionality of control processes and the significance of the residual risks.
    b. Enhances employees' understanding of business risks and controls and encourages communication and cooperation among them.
    c. Early identification of risks and improvement of the general risk-control environment.
    d. Provides internal auditors with more on-hand information about the control processes, (thus enabling them to directly concentrate their efforts on weak areas).

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5. **CSA Approaches –** There is a wide variety of approaches used for CSA processes. The approach used needs to be suitable for the unique characteristics of the organization and should be dynamic so as to respond to organizational change and development:
    a. **Facilitated team** where work teams of different levels in the function hold discussions leading to a rough report. The report is then reviewed by the group. Such workshops may take several forms, as follows:
        i. **Risk-based format:** A comprehensive method whereby members considering all possible risks that may hinder goal achievement, assess related controls for effectiveness, and highlight residual risks.
        ii. **Control-based format:** Having the risks and controls already identified for them, team members in this type of workshop assess the effectiveness of the controls against management's expectations.
        iii. **Process-based format:** Focuses on selected activities in processes. Members identify the objectives of, and aim at generally developing, the process and its component activities.
        iv. **Objective-based format:** Focuses on determining the best way to achieve business objectives. Members examine the effectiveness of controls in supporting the objectives and then check the level of the residual risks for reasonableness.
    b. **Questionnaire –** is another approach of CSA used in gathering information on risks and controls within the organization. Questionnaires typically include simple "yes-no" questions that are easy to understand. Questionnaires usually save time and money and ensure more honest feedback.
    c. **Self-certification approach –** in this approach the internal auditors use the information gathered from managers' assertions about the state of internal controls within their units or functions. The internal auditors may synthesize these certifications with other information to enhance the understanding about controls and to share the knowledge with managers in business or functional units as part of the organization's CSA program.
6. The internal audit activity's role in the CSA program could range from owning the process (designing, implementing, etc.) to playing the role of consultant and verifying the final evaluations.

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B. Audits of Third Parties and Contract Auditing

1. **External Business Relationships** – The following guidance is obtained from the IIA's Practice Guide, Auditing External Business Relationships:
    a. Organizations often use external business relationships to satisfy a variety of business needs and accomplish their objectives. With these business relationships also come inherent and control risks associated with working with external business partners.
        i. It is management's responsibility to manage these risks and achieve the benefits.
        ii. Internal auditors can help management and the board identify, assess, and manage these risks.
    b. Examples of external business relationships include
        i. **Service provider** such as payroll processing, IT services, internal audit outsourcing, or call centers.
        ii. **Supply-side partners** such as production outsourcing, R&D outsourcing, suppliers, or vendors.
        iii. **Demand -side partners** such as distributor, franchisee, licensee.
        iv. **Strategic alliances and joint ventures**.
        v. **Intellectual property partners**.
    c. The following are examples of risks associated with external business relationships. The internal auditor needs to be alerted to these risks when auditing external business relationships:
        i. External business partner's actions may adversely affect the organization's reputation by violating laws or regulations, misrepresenting the organization's values, or not complying with contractual obligations.
        ii. The external business partner may not maintain adequate insurance coverage.
        iii. Disputes or disagreements may arise regarding the scope of services between the organization and its external business partner.
        iv. The external business partner may have conflicts of interest in providing services. For example, quality or timeliness of work may be adversely affected due to contractual obligations to others.
        v. Intellectual property licensed to others could be receiving inappropriate royalty streams due to theft, or misuse of ideas or technology.
        vi. The organization may be overcharged for inefficiencies or services not performed.

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vii. The external business partner may become insolvent, go out of business, or become unable to fulfill contractual obligations.

viii. The organization's confidential information shared with the external business partner may be exposed, which may result in competitive, reputational or legal risks.

d. **Auditing External Business Relationships** – the general steps for auditing external business relationships are as follows:

i. **Understand the organization**, its environment, and the nature of each external business relationship.

ii. **Assess risks and controls** – The internal auditor assesses the risk to the organization associated with the external business relationship. This includes:

- Determine potential impacts on the organization in the absence of any controls of inherent risks that the organization has assessed, along with those that the internal auditor has identified and assessed.
- Understand the design of controls the organization has put in place to mitigate risks.
- Determine the key controls, which if not effective would mean the risks are not mitigated.
- Understand the external business partner's environment, processes, and controls.
- Determine whether the external business partner's internal auditor has performed work relating to the contract with the organization.

iii. **Perform Audit Procedures** – Based on the audit objectives, the internal auditor determines if audit procedures need to be performed at the external business partner. Some external business partners may not allow access by a business partner's internal audit activity unless the contract provides access.

- For example, if the organization has outsourced its information systems processing facilities to a third party (external business relationship), its continued processing would be dependent on the third party. The internal auditors may be assigned with the approval of the third party to audit the third party to ensure that all risks that may affect its ability to provide continuous service are mitigated through adequate and effective controls.

iv. **Report and monitor progress** – The internal auditors determines the frequency and content of reports to the board and senior management, and determine whether findings have been addressed appropriately.

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2. **Audits by Third Parties**
    a. The organization itself may also be subject to audit by one or more of its external business partners. In these cases, the internal auditors of the organization should coordinate audit activities with the auditors of the third party to share information and prevent duplication of effort.
3. **Contract Auditing**
    a. **Contract auditing** usually refers to auditing construction-type contracts or contracts for the manufacturing of special equipment or machinery.
    b. Contracts may generally be classified into three main categories:
        i. **Lump-sum contracts** are contracts that mention a total price in accordance with detailed specifications and/or contract requirements. More complex lump-sum contracts usually include details on progress payments, escalation clauses, delay penalties, and adjustments for some costs such as field labor, or significant raw materials. Further, these contracts rarely are completed without modifications during the execution phase. When these contracts are executed as contracted with no major changes, there is usually little to audit by the auditor. Audit challenges arise as a result of changes to the contract terms and/or during the execution phase of a long-term contract in the presence of complicated contract details.
        ii. **Cost-plus contracts** are contracts whereby the buyer will pay the cost plus a fixed amount or a percentage of cost to the contractor. Although both are options, the percentage of cost is not usually preferred since that would create a motive for the contractor to increase costs unnecessarily. This type of contract is used when dealing with projects with numerous and significant unknowns. This type of contract requires special audit attention since the cost-saving motive may not be emphasized when the contract is being executed.
        iii. **Unit-price contracts** are contracts where the cost-per unit is set but the total units will be quantified as the contract is executed. For example, the contract may be to demolish a building and clear the debris. The contract may be priced based on the volume in cubic feet of debris removed.
    c. Audit participation in the above contracts should start in the early phases of the contract negotiations to support in the evaluation of the following:
        i. Bidding procedures
        ii. Cost estimates and cost control
        iii. Tax treatments
        iv. Financial forecasting, availability of resources, and sources of funding
        v. Contract terms
        vi. Contractors' accounting and management systems

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vii. Required performance bond

viii. Progress payment plans

d. The involvement of experienced internal auditors in contracts would allow them to focus on safeguarding organizational resources from potential risks. The following are lists of potential risks in the three types of contracts taken from Sawyer's Internal Auditing 5th edition pages 311-312:

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Risks in Contracts

1. **Lump-sum contracts:**
   - Inadequate competition
   - Inadequate insurance and bond coverage
   - Certification of completion when work is not completed
   - Charges for equipment or activities that are not received
   - Escalation provisions
   - Changes in specifications or prices
   - Authorization for extras and revisions
   - Extras, changes, and revisions that are already part of the original contract
   - Overhead items included as additional charges
   - Content of change orders, including appropriate fees
   - Inadequate inspection relative to specifications
2. **Cost-plus contracts:**
   - Overhead costs also billed directly
   - Inadequate internal controls by contractor over charges for people, materials, and services
   - Unreasonable charges for use of contractor-owned equipment
   - Excessive manning of project
   - No effort to obtain best prices for materials and equipment
   - Billings in excess of the amounts the contractor pays for labor or material
   - Failure to credit project for discounts, insurance rate refunds, returned or salvaged material
   - Duplication of effort or costs between headquarters and field offices
   - Inadequate job-site supervision or inspection by contractor or by architect-engineers
   - Inadequate communication and follow-up from headquarters office
   - Unreliable cost accounting and reporting procedures by contractor
   - Billing supervision as direct labor in violation of contract terms
   - Idle rented equipment
   - Poor work practices
   - Poor quality
   - Extravagant use or early arrival of materials and supplies
   - Excessively high standards for materials and equipment
   - Poor physical protection of materials and equipment
   - Lack of control over absences of contractor employees
   - Cost-plus type work of contractor going simultaneously with fixed-type work
   - Excessive costs incurred because of contractor's negligence
   - Uncontrolled overtime
3. **Unit-price contracts:**
   - Excessive progress payments
   - Improper reporting of units completed
   - Prices bearing no relation to cost
   - Improper changes to the original contract
   - Unauthorized escalation adjustments
   - Inaccurate field records
   - Inaccurate extension of unit prices

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C. Quality Audit Engagements

1. **Quality** refers to the degree of which a product or service meets its specifications. Quality only ensures that the products or services are consistent, but that does not necessarily mean or imply “higher quality” products or services. Quality should be the responsibility of all parties in the organization.
2. **Total Quality Management (TQM)** is the comprehensive approach to emphasize quality in all aspects of the organization from the supplier to the consumer. It involves a form of management with the focus on:
    a. Customers
    b. Environment of trust and openness
    c. Teams, leadership and coaching
    d. Shared power
    e. Continuous improvement
    f. Breakdown of internal organizational barriers
3. TQM emphasizes that top management commitment is central to any successful TQM implementation.
4. TQM is a continuous process that requires continuous monitoring through ongoing data collection, evaluations, feedback, and improvement programs.
5. A properly implemented and effective TQM system should result in:
    a. Greater customer satisfaction
    b. Fewer defects and thus less waste
    c. Improved total productivity
    d. Reduced costs and thus better profitability
6. **Quality audit engagements** refer to audits of a function or unit in the internal audit universe to ensure it is meeting defined quality standards.
    a. If there are no defined standards, the auditor coordinates with management and the related department to establish such standards.
    b. In organizations where a quality assurance department and/or quality team performs regular audits, the internal auditor could coordinate with such department. Further, the department itself would be part of the internal audit universe.

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D. **Due Diligence Audit Engagements**

1. **Due diligence audit engagements** refer to very limited and specific audits of specific areas of third parties that the organization has interest in. It refers to the reasonable care an organization should take before entering into a contract or a financial transaction with another party.
    a. For example, a bank granting a loan to an organization in return for a pledge over its inventories or accounts receivable may perform a due diligence audit to ensure their existence and valuation.
2. Due diligence audit assignments are also performed to assist in the management decision making when joint-ventures, mergers, or other similar transactions are involved.
    a. For example, a potential acquirer targeting a company for acquisition may perform a due diligence audit to evaluate the company or its assets.
3. Usually, the external auditors, internal auditors and legal counsel get involved in a due diligence audit engagement, and the resulting report is delivered to management for decision making.

E. **Security Audit Engagements**

1. **Security audit engagement** refers to an audit whereby the internal auditors assess controls to mitigate exposure to security threats and provide assurance on the organizational physical and logical security.
2. The responsibility for security rests with senior management, but security is part of the internal auditors' audit universe when prioritizing and selecting engagements. The role of the internal audit activity relating to security is to evaluate the effectiveness of the current security of organizational resources and information systems commensurate with the risk of exposure and cost of implementing a security system. If weakness or security exposures are identified, they must be reported appropriately.
3. The various exposures and related controls detailed in this section.

F. **Privacy Audit Engagements**

1. **Privacy** is the individuals' rights of being left alone including not disclosing any pertinent information about themselves directly or indirectly by other individuals and/or entities who happen to possess such information in due course. Such information includes, for example, bank accounts, credit card information, contact information, etc.
2. Risks associated with the privacy of information encompass personal privacy (physical and psychological), privacy of space (freedom from surveillance); privacy of communication (freedom from monitoring); and privacy of information (collection, use, and disclosure of personal information by others)

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3. Lack of adequate privacy controls can negatively affect both individuals (harm, inconvenience, etc.) and the organization (lawsuits, fines, negative customer goodwill, etc.).
4. Privacy is protected by numerous laws, statutes, and acts, in addition to being necessitated by the organization itself and/or the related individuals, and thus, organizations must ensure that their information systems are adequately safeguarded to avoid privacy vulnerabilities.

G. Performance Audit Engagements

1. A performance audit engagement is an audit designed to provide assurance regarding an organization's performance measurement system. Internal auditors may conduct a performance audit as an assurance audit, or they may be required by management to conduct a consulting engagement to design or improve the performance management system.
2. The performance measurement system involves collecting, evaluating and communicating information about the performance of an organization, an operation, a function, or a component. The performance measurement system provides vital information about how different business units of the organization have performed. This information is essential for making strategic planning and control decisions.
3. The internal auditor assesses the adequacy of the performance measurement system for the achievement of the corporate objectives. The performance measurement system must typically ensure that both individual and corporate objectives are aligned.
4. A successful performance measurement system should create and manage key performance indicators (KPIs). Through a performance audit, internal auditors evaluate how well an organization is achieving its objectives for its key performance indicators.
    a. **Key Performance Indicators** (KPIs) can be defined as a set of measurable business metrics that an organization uses to gauge or compare performance in terms of meeting its strategic and operational goals crucial to the success of the organization.
    b. Importance of KPIs
        i. KPIs help organizations to understand how well they are performing in relation to their strategic goals and objectives.
        ii. KPIs provide performance effectiveness and continuous improvement of the organizations operations.
        iii. KPIs help in monitoring the effects of process changes reliably, repeatedly and accurately.
        iv. KPIs are periodically used to assess the performances of an organization as a whole, its divisions, its departments, or its employees.

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v. KPIs detect potential problems, which results into process remediation and improvement.

vi. KPIs help the organization's management with making informed decisions.

c. The KPI Development Process – to develop KPIs, the following steps/questions are answered:

i. Overall business strategy - What is the organization trying to achieve?

ii. Goals/Objective - What are the short and long-term objectives of the organization to achieve the strategy?

iii. Key Business Drivers - What are the key steps set to achieve the goals and objectives?

iv. (KPIs) - What measures of success or indicators are associated with the key business drivers?

v. Support Metrics - What are the detailed measures that support the KPIs?

5. Another approach for performance measurement is the balanced scorecard approach.

a. **The Balanced Scorecard** refers to a management concept that assists management at all levels to monitor the results of their key areas. The concept measures current performance in addition to assessing the organization's positioning for future performance. An organization-wide scorecard would flow from top-management levels all the way down and thus each member of the organization would have their own scorecard goals that they aim to achieve, and ultimately, contribute to meeting the strategic corporate goals.

b. The key areas typically emphasized by the balanced scorecard concept are:

i. Internal business processes (operational efficiency) – "What must the organization standout with?"

ii. Financial performance – "Is the organization adding value to the shareholders?"

iii. Customers – "What is the customer's attitude towards the organization?"

iv. Learning, growth, and innovation – "What is required of the organization to increase value added activities?"

c. For each of the key areas emphasized by the balanced scorecard, the organization should recognize its critical success factors, and means of measuring those factors.

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6. **The Risk Impact of Performance Measurement Systems**
    a. The performance measurement system of an organization has significant indications and implications on the overall control environment, and on potential risk factors that the auditor may need to focus on. For example:
        i. If the income of the senior managers of a company is highly dependent on bonuses that are paid when certain income thresholds are met, management may be overly motivated to apply accounting methods and practices that will reflect the generation of high income levels especially when the true operations of a company are not as good.
        ii. If low level employees are significantly underpaid commensurate with their tasks and the job market, yet there is an apparent overall satisfaction with their jobs, it could imply that the employees have exploited a loophole in the internal control environment that allows them to fraudulently support their incomes.
7. The performance measurement system, including the balanced scorecard and KPIs, is discussed with more details in Domain-II of Part-3.

H. **Operational Audit Engagement** is an audit to test whether the functions within the organization are **effective** in achieving their objectives, and are operating **efficiently and economically**. The following are typical operational audit engagements:

1. **Economy and Efficiency Audit** is an audit of a certain function or activity concentrating primarily on the **economy and efficiency** of the function to test:
    a. Whether the entity is obtaining and using its resources economically and efficiently.
    b. The reasons for inefficiencies, if applicable; and
    c. Compliance with related laws and regulations pertaining to issues of economy and efficiency.
2. **Program (Program-results) Audit** is an audit of a certain program or activity concentrating primarily on the **output** (thus effectiveness)**.** It involves **testing against established criteria** to assess:
    a. The achievement of the desired objectives that are preset.
    b. The effectiveness of the programs or activities in achieving the desired objectives; and
    c. Compliance with related laws and regulations pertaining to the program or function under audit.

Passing Tip:	Determination of cost savings is most likely to be an objective of operational audit engagements.

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I. Financial Audit Engagements

1. **Financial Audit** is an audit of the economic activity to test the reliability and integrity of reported financial information and to ascertain that the company's assets are safeguarded.
    a. Providing assurance regarding financial reporting is required by the IIA's Standards. According to the Standards, "The internal audit activity must evaluate risk exposures relating to the organization's governance, operations, and information systems regarding the:
        i. Achievement of the organization's strategic objectives.
        ii. **Reliability and integrity of financial and operational information.**
        iii. Effectiveness and efficiency of operations and programs.
        iv. **Safeguarding of assets.**
        v. Compliance with laws, regulations, policies, procedures, and contracts."
2. **Management Assertions** (or financial statements assertions) are the explicit or implicit assertions made by an organization's management regarding the information contained in its financial statements. The typical objectives of a financial audit involve testing management assertions to determine whether they are reliable and supported by evidence. Management assertions regarding financial statements usually include:
    a. **Existence or occurrence –** i.e., assets and liabilities existed at a given date and transactions occurred during the period under audit.
    b. **Completeness –** i.e., all transactions and accounts that should have been recorded were actually recorded and included in the financial statements.
    c. **Rights and obligations –** i.e., the company has the rights to its reported assets and has the obligations recorded under liabilities.
    d. **Valuation or allocation –** i.e., the reported amounts for assets, liabilities, revenues, and expenses are appropriate in accordance with the accounting standards used.
    e. **Presentation and disclosure –** i.e., financial statement accounts are properly presented, classified, disclosed, and described.
3. Financial audits are normally conducted by external auditors, however, they are also part of the internal audit universe. Coordination with external auditor is preferably made in these audits to minimize duplicate efforts and ensure optimum audit coverage using the organization's scarce resources.
4. The internal audit roles in financial audits include also providing assurance regarding the effectiveness and efficiency of internal controls over financial statements.

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J. **Environmental Audit Engagements** – Environmental audit engagements should be conducted as part of an environmental management system of an organization. The typical objective of environmental audits is to determine whether the organization's environmental controls are adequate and effective in addressing all environmental risks to the organization. Types of environmental audits include:

1. **Environmental compliance audit** is a site-specific, detailed audit of on-going operations, past practices, and/or planned future operations to test for compliance with environmental laws.
2. **Environmental management system audit** ascertains that the systems are operating properly to curtail any future environmental risk.
3. **Transactional audit** is an audit to assess the potential risk/liability of a real property as a result of environmental contamination. (Also referred to as Acquisition and Divestiture Audits, Property Transfer Site Assessments, Property Transfer Evaluations, and/or Due Diligence Audits)
4. **Treatment, storage, and disposal facility audit** is the audit of the tracking (cradle-to-grave) of hazardous materials documents and treatments. Any party involved with such hazardous materials may ultimately become liable if such materials cause any future environmental damage.
5. **Pollution prevention audit** refers to the elimination of the pollution at source through the following hierarchy:
    a. Recovery as a useable product
    b. Elimination at source
    c. Recycling and reusing
    d. Conserving energy
    e. Treatment
    f. Disposal
    g. Release
6. **Environmental liability accrual audit** is the process of recognizing, quantifying, and reporting liability accruals for environmental issues.
7. **Product audit** is the audit of a product to ensure that it is in compliance with current environmental requirements.

K. **IT Audit**

1. IT audit can be defined as any audit that encompasses review and evaluation of automated information processing systems, related non-automated processes and the interface between them.

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