CHAPTER 8
INTERNAL AUDITING'S SYSTEMATIC, DISCIPLINED PROCESS

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The Professional Practices Framework for Internal Auditing (PPF) was designed by The IIA Board of Directors' Guidance Task Force to appropriately organize the full range of existing and developing practice guidance for the profession. Based on the definition of internal auditing, the PPF comprises *Ethics* and *Standards, Practice Advisories,* and *Development and Practice Aids,* and paves the way to world-class internal auditing.

This guidance fits into the Framework under the heading *Development and Practice Aids*.

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I. Introduction

The Institute of Internal Auditors' (IIA's) *Definition of Internal Auditing* introduces internal auditing as a "systematic, disciplined approach" (IIA, 1999b). According to the Guidance Task Force that framed the definition, this distinctive approach is the "heart and soul of internal auditing's unique franchise" and "the primary basis for the profession's success" (IIA, 1999a, 8). The approach, which is applicable to the entire range of assurance and consulting activities encompassed by the definition, is chronicled in the *Standards for the Professional Practice of Internal Auditing* (*Standards)* (IIA, 2001b).

This chapter discusses the systematic and disciplined process of internal auditing. The chapter:

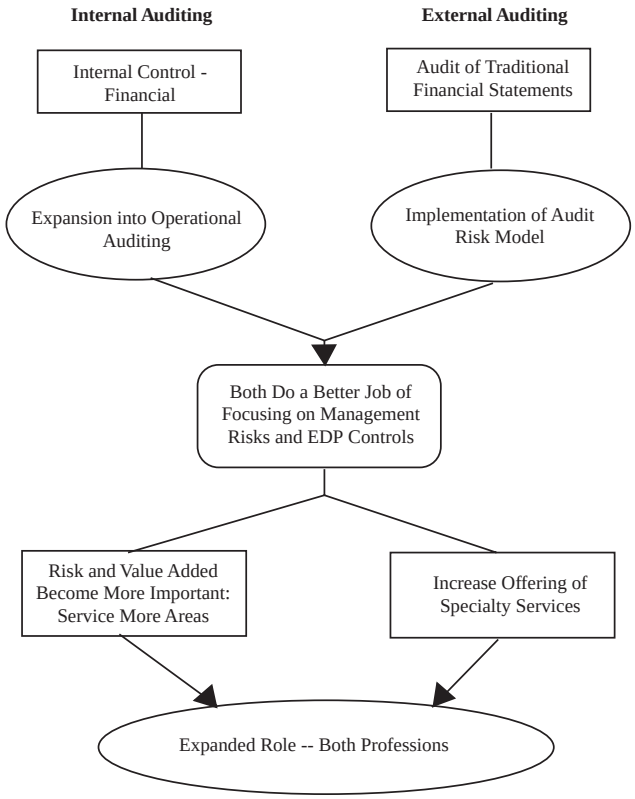
- Examines the parallel development of the internal and external auditing processes.
- Introduces a model that provides a context for the internal auditing process along three dimensions — "engagement type," "degree of cosourcing," and "organization characteristics."
- Examines the internal auditing process itself using the framework of an engagement enunciated in the *Standards* — planning the engagement, performing the engagement, and communicating the engagement results.

As we developed this chapter, we identified many interesting and important issues related to the internal auditing process. In this chapter, it was not our purpose to develop these issues. Rather, we simply framed them as questions for future investigation. The questions are presented at the end of each section and summarized in Appendix 1.

II. Recent Changes in Internal and External Auditing

Auditing processes for both internal auditors and external auditors have changed in the past eight to 10 years. Factors that prompted these changes included the globalization of business, advances in technology, and demands for value-added audits. Some accounting firms and internal audit functions (IAFs) responded by modifying their audit methodologies to incorporate a "business risk" approach to auditing. Exhibit 8-1 illustrates these changes in practice, which initiated changes in both internal and external auditing standards. The ensuing discussion is cursory; the interested reader is referred to *The Outsourcing Dilemma: What's Best for Internal Auditing* (Rittenberg and Covaleski, 1997) and *Developments in the Audit Methodologies of Large Accounting Firms* (Lemon, Tatum, and Turley, 2000) for a more complete discussion of this evolution.

Exhibit 8-1
Convergence of Internal Audit and External Audit Functions



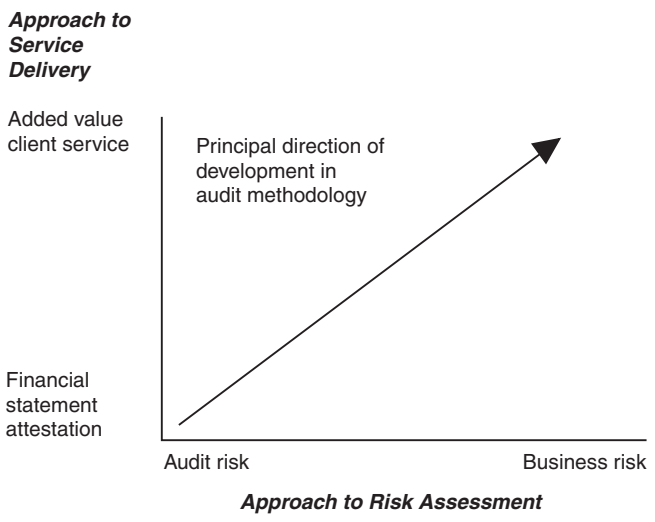
Source: *The Outsourcing Dilemma: What's Best for Internal Auditing* by Larry E. Rittenberg and Mark A. Covaleski, p. 51. Copyright 1997 by The IIA Research Foundation, 249 Maitland Avenue, Altamonte Springs, Florida 32701-4201, U.S.A. Reprinted with permission.

In 1997 The IIA appointed the Guidance Task Force to study the gap between evolving internal auditing practice and internal auditing standards to determine how existing standard-setting processes and guidance could be improved. The Guidance Task Force's key recommendations included revising the definition of internal auditing and creating a new professional practices framework (IIA, 1999a, 1). In June 1999 The IIA approved a new

definition of internal auditing that encompasses an expanded scope of services, embraces risk management, control, and governance processes, and emphasizes adding value to an organization. In December 2000 The IIA issued new *Standards* that elaborate on this "business risk" approach of internal auditing.

In 1998 Canada, the U.S., and the UK formed the Joint Working Group (JWG) to study the audit methodologies of the largest accounting firms. The JWG found that some firms' methodologies required the auditor to understand the organization's strategic objectives and the related risks and controls. This "business risk" approach emphasizes high-level controls (e.g., control environment factors such as the audit committee) and monitoring controls over business processes and relies on audit evidence that historically has been considered soft evidence (e.g., analytical procedures, inquiry, and observation). The accounting firms believed that this increased focus on "knowing the business" led to a more effective and efficient audit and, in turn, a more value-added service for their attest clients. Exhibit 8-2 illustrates this change in audit methodologies.

Exhibit 8-2
Approach to Audit Risk



Source: *Developments in the Audit Methodologies of Large Accounting Firms* by W. Morley Lemon, Kay W. Tatum, and W. Stuart Turley, p. 11. Copyright 2000 by Professors W. Morley Lemon, Kay W. Tatum, and W. Stuart Turley. Reprinted with permission.

In 2000 the JWG issued a report that was distributed to the International Auditing and Assurance Standards Board (IAASB) (previously the International Auditing Practices Committee), and the auditing standard-setting bodies in Canada, the U.S., and the UK (JWG, 2000). The overall recommendation was that the IAASB should change existing international auditing standards to incorporate the "business risk" approach. At its September 2002 meeting, the IAASB voted to issue three exposure drafts of proposed auditing standards (commonly referred to as assessing risk, linkage, and audit evidence) that introduce many of the attributes of the "business risk" approach to auditing into the international auditing standards.

We believe that it is important to consider the changes from the perspective of both internal auditors and external auditors to understand how the internal auditing process has changed and is changing. Research about the external auditing process can be used as a platform for identifying research issues about the internal auditing process. For example, the JWG (2000) identified challenges in implementing the "business risk" approach including:

- Auditors may not possess the skills to understand certain aspects of business risks.
- Auditors may not have access to the databases that assist in the risk assessment process.
- Auditors of smaller organizations may believe that the audits of such organizations can be efficiently undertaken without a broad consideration of the organization's business risks.
- Regulators and others may perceive that an approach, which places increased reliance on analytical procedures and testing of high level controls, lacks rigor.

When the JWG conducted its study, there was little evidence to support the efficiency or the effectiveness of the "business risk" approach in external audits. While the firms believed that the "business risk" approach was a better way of performing audits, there was no evidence to support this assertion. Slowly, evidence is emerging (Ballou, Earley, and Rich, 2002; O'Donnell and Schultz, 2002; Eilifsen, Knechel, and Wallage, 2001). Similarly, research is needed regarding the implementation of the "business risk" approach to internal auditing that is articulated in the *Standards*, recognizing the unique aspects of internal auditing (e.g., organizational and staffing issues discussed in the ROIA chapter by Prawitt and independence and objectivity issues discussed in the ROIA chapter by Mutchler).

Research Questions

- Is the convergence suggested by Rittenberg and Covaleski in their 1997 report continuing or was it an artifact of the organizations they interviewed?

- What, if any, impact have recent financial debacles such as Enron and WorldCom had on changes in the internal auditing approach suggested by Rittenberg and Covaleski (1997)?

- Is the IAF moving in the same direction as Lemon, Tatum, and Turley suggested the external auditing profession was moving?

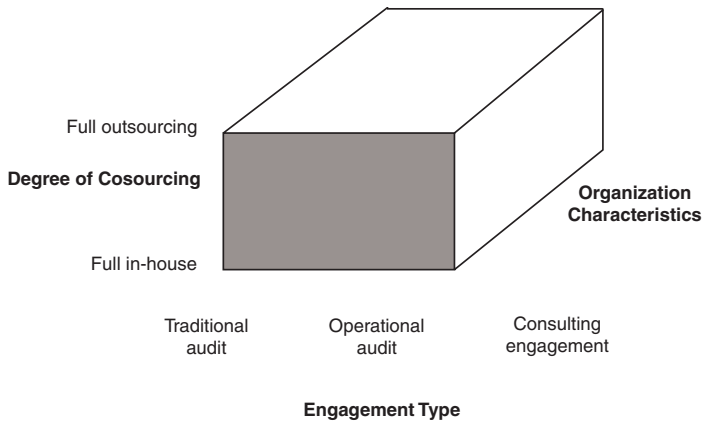
III. The Model

We believe that the context for the internal auditing process can best be envisioned if one thinks of the IAF as being a point in a three dimensional space. The three dimensions are:

- "Engagement Type."
- "Degree of Cosourcing."
- "Organization Characteristics."

The model (see Exhibit 8-3) presents our view of the context in which all, or at least most, internal audits can be classified.

Exhibit 8-3
The Model



Engagement Type

Engagement type is a continuum ranging from an internal audit that consists completely of tests of controls which may also be described as a traditional, compliance, or tick-and-tie audit (**Traditional Audit** in our model) through an internal audit that consists completely of tests of operations/performance (**Operational Audit** in our model) to a consulting engagement (**Consulting Engagement** in our model). We understand that a **Traditional Audit** and an **Operational Audit** are almost always assurance engagements while a **Consulting Engagement** is simply that. There is a range of activities subsumed under the rubric "consulting." These activities include but are not limited to (IIA, 2001a, Practice Advisory 1000.C1-2):

- Formal consulting engagements (e.g., planned and subject to a written engagement).
- Informal consulting engagements (e.g., participation on standing committees, limited-life projects).
- Special consulting engagements (e.g., participation on a merger and acquisition team or system conversion team).
- Emergency consulting engagements (e.g., participation on a team established for recovery or maintenance of operations after a disaster or a team assembled to supply temporary help to meet a special request).

Chapter 4 provides a continuum of internal audit activities, which the author (Anderson) calls the Assurance/Consulting Continuum. The continuum is a more detailed version of the "Engagement Type" continuum in our model. Anderson raises issues about assurance and consulting services that can be examined using the model as a context. For example, issues related to assurance services and consulting engagements could be considered in the context of degree of cosourcing and organization characteristics.

Cosourcing

Two principal groups provide internal auditing services to organizations: in-house providers (IPs) and outside providers (OPs). IPs include internal audit departments in public companies, private companies, government organizations, and not-for-profit organizations. OPs include organizations such as Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP, PricewaterhouseCoopers LLP, Jefferson Wells International Inc., and Protiviti (formed by former Andersen personnel), which provide outsourced internal auditing services. After a number of conversations with the practice leaders of the major OPs in Canada (as contrasted

with IPs), we believe that "degree of cosourcing" is important for a discussion of the internal audit process. OPs have a diversity of clients while IPs have only a single client. As discussed in the ROIA chapter by Anderson, both IPs and OPs have a wide diversity of potential auditees or clients within a given organization. However, the IP exists within a single organization while the OP serves multiple organizations. The range of cosourcing is from "full in-house" (0 percent cosourced) to "full outsourced" (100 percent cosourced). We have assumed that in all cases there is a director of internal audit or equivalent. Chapter 6 provides additional information about sourcing and other flexible staffing arrangements.

Organization Characteristics

Factors that exist in the organization's external environment and other factors that are unique to the organization potentially can affect internal audit processes. We refer to these factors as "organization characteristics" and recognize that there are several possibilities for this dimension, including:

- Industry.
- Country.
- Legal environment.
- Size of organization.
- Organizational culture.
- Composite skill set of IAF.

Industry

We believe there is a series of discrete industry types within which there may be subtypes (for example, a discrete industry type might be Financial Services and subtypes might be Insurance and Banking). Our conversations with OPs led us to believe that while inter-organizational audits of the same industry type might be similar, we should leave that as a researchable question.

Country

As discussed earlier, globalization of business caused some IAFs to adopt a "business risk" approach to auditing. O'Regan (2001) identifies and discusses various issues (e.g., currency, political, cultural, and environmental) that the IAF should consider when auditing an organization in a country other than the organization's domicile.

Legal Environment

The legal environment includes laws and regulations. For example, the Sarbanes-Oxley Act of 2002 prohibits the external auditor from performing certain activities, including internal audit outsourcing services. The law also requires chief executive officers (CEOs) and chief financial officers (CFOs) to certify the accuracy of the financial statements and external auditors to report on management's assessment of internal controls. At the time of this writing, the New York Stock Exchange (NYSE) has proposed that all companies be required to have a functioning IAF as a condition of listing. It is not clear how much if any cosourcing would be allowed under the proposed rule. These new laws and regulations likely will impact the type of internal audit engagements and the degree of cosourcing.

Size of Organization

The IAF exists in organizations that vary in size from small to large. Recall that the JWG suggested that the "business risk" approach might have to be modified for audits of small organizations. Carey, Simnett, and Tanewski (2000) found that outsourcing was the most common method for providing internal auditing services to family businesses.

Organizational Culture

What is the organization trying to achieve with the IAF? For example, does the organization view the IAF as exiting to assist management in managing risk or does the organization view the IAF as existing simply to satisfy legal or regulatory constraints? What is the role of the IAF in the organization — management training for eventual placement in a management position in some other part of the organization or training for a career in internal auditing? For example, at General Electric internal audit serves as a Center of Excellence and a training ground for managers. At Caterpillar the IAF serves as an entry-level position for corporate accountants. The answers to the question would seem to impact on the type of engagement and the degree of cosourcing. Chapter 6 covers these issues more fully.

Composite Skill Set of IAF

There are a number of staffing and training issues discussed in Chapter 6 that could be examined using the model as a context. For example, the structure of the IAF or staffing the IAF could be considered in the context of engagement type and degree of cosourcing.

Research Questions

- Does the model reflect reality? Can internal auditing be so categorized? Do these three dimensions capture the necessary components of internal auditing's systematic, disciplined process?

- Assuming the model does reflect reality, do internal audits differ across all three dimensions? If so, how?

- Are there substantive differences between the engagements performed by internal and outside providers? Is the extent of cosourcing a factor?

- Is there a difference in engagement type across different industries?

- Do organizations migrate from a traditional audit to an operational audit and from an operational audit to a consulting engagement? If they do, what causes the migration?

- Do organizations migrate from an operational audit to a traditional audit? If they do, what causes the migration?

- Do organizations migrate along the cosource continuum? If so, what causes the migration?

- How are costs and benefits assessed both ex ante and ex poste in the decision to migrate to greater cosourcing?

- What is the role of organizational culture in determining: (a) Whether the IAF is performed by an internal or outside provider? (b) The degree of cosourcing if an outside provider is used? (c) Whether a traditional audit or operational audit or consulting engagement is appropriate?

- Is there a correlation between the level of cosourcing and the migration from traditional audit to operational audit to consulting engagement?

- What is the role (mandate) of internal auditing in the organization? Management training or internal audit? How does this role influence the degree of cosourcing and the engagement type?

- The New York Stock Exchange has proposed that all companies be required to have a functioning IAF as a condition of listing. What are the implications for degree of cosourcing and types of engagements?

- The Sarbanes-Oxley Act of 2002 prohibits the external auditor from performing certain activities, including internal audit outsourcing. What are the effects on outsourcing?

IV. Framework of an Engagement

The Introduction to the *Standards* (IIA, 2001b) states:

> *Internal audit activities are performed in diverse legal and cultural environments; within organizations that vary in purpose, size, and structure; and by persons within or outside the organization. These differences may affect the practice of internal auditing in each environment. However, compliance with the Standards is essential if the responsibilities of internal auditors are to be met.*

Standards 2200, 2300, and *2400* set forth the basic requirements for planning and performing internal audits and communicating engagement results, thereby providing a framework of the internal audit process. As noted above, the differences among organizations' environments as well as the providers of internal audit activities influence individual engagements. We believe that these differences are captured by the three dimensions of the model (engagement type, degree of cosourcing, organization characteristics) introduced in the prior section. The potential impact of these differences is pointed out in the following discussion of the internal audit process.

Planning the Engagement

The *Standards* require the IAF to develop and document an engagement plan. This process involves considering objectives, risks, and controls to obtain knowledge about the activity being reviewed, setting engagement objectives based on a risk assessment, establishing an engagement scope that is sufficient to satisfy the engagement objectives, determining appropriate resources to achieve the objectives, and developing a work program that achieves the engagement objectives.

Planning Considerations

Standard 2201 introduces the "business risk" approach into the internal auditing process. The standard requires the IAF to obtain knowledge about the activity's objectives, risks, and related controls. In addition, the IAF must evaluate the controls against a relevant control framework. The framework may be a recognized framework — for example, the COSO framework discussed in Chapter 2. Or, the framework may be organization specific. Burr, Gandara, and Robinson (2002) describe a unique control framework developed at Morgan Stanley. In addition, the IAF should consider opportunities for making significant improvement to the activity's risk management and control systems. This consideration enables the IAF to add value to the organization. Lindow and Race (2002) report how Cal-Fed's risk-based audit approach enabled the IAF to add value by improving the organization's risk management strategies.

A technique that is often used in internal audits at the planning stage is control self-assessment (CSA). The IIA defines CSA as:

> *. . . a process through which internal control effectiveness is examined and assessed. The objective is to provide reasonable assurance that all business objectives will be met (IIA, 1998).*

The distinguishing characteristic of CSA is that the IAF does not perform the assessment. Instead, managers and line employees evaluate controls. The IAF normally participates in the process as a facilitator. The IAF can use CSA to target audit work by reviewing high risk and unusual items noted in CSA results. In addition, the IAF can use CSA to increase the scope of coverage of internal control reporting during a given year.

The three basic formats of control-self assessment are workshops, questionnaires, and management-produced analysis (IIA, 1998). Organizations often use a combination of approaches. If an organization's culture is supportive, The IIA recommends the workshop format (IIA, 1998). Other factors that determine the best approach include the nature of the industry, the expertise and experience of the IAF, the attitude and support of management for the IAF, and the attitude of the audit committee toward the IAF (Hubbard, 2000). Tritter and Zittnan (1996) studied the benefits and concerns associated with CSA from varying perspectives. Additional research is warranted.

Engagement Objectives

Standard 2210 states that the engagement's objectives should address the risks, controls, and governance processes associated with the activities under review. When planning an assurance engagement, the IAF should identify and assess risks relevant to the activity under review. Risk assessment assists the IAF in identifying significant areas of activity that should be examined (Practice Advisory 2210-1). Risk assessment activities include obtaining background information (e.g., objectives and goals), conducting a survey (e.g., discussions with client, interview with individuals affected by the activity, on-site observations) and reviewing management reports and studies (e.g., analytical auditing procedures, flowcharting) (Practice Advisory 2210.A1-1). The engagement's objectives should reflect the results of the risk assessment. On consulting engagements, the IAF and the client should agree upon the extent to which the engagement objectives will address risks, control, and governance processes. Chapter 5 provides a thorough discussion of risk from the perspective of the IAF.

When developing objectives for an assurance engagement, the IAF should specifically consider the probability of significant errors, fraud, noncompliance, and other exposures. Fraud includes an array of irregularities and illegal acts characterized by intentional deception. The principal mechanism for deterring fraud is control. Management has the primary responsibility for establishing and maintaining control and for establishing the overall tone and ethical standards within the organization. The IAF assists in the deterrence of fraud by examining and evaluating the internal control, commensurate with the extent of the potential exposure/risk in the various segments. Although the IAF is not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud, the IAF should have sufficient knowledge to identify the indicators of fraud *(Standard 1210)*. See Chapter 4 for a further discussion of the role of the IAF with respect to fraud.

Church, McMillan, and Schneider (2001) investigated internal auditors' consideration of fraudulent financial reporting in an analytical procedures task. Their findings suggest a positive relationship between internal auditing experience and participants' beliefs about fraud. They suggest future research about how experience affects stores of knowledge and performance across internal auditing tasks. This research should focus on a homogeneous group — for example, internal auditors employed by financial institutions.

Engagement Scope

The IAF should determine that the scope of the engagement is sufficient to satisfy the objectives of the engagement *(Standard 2220)*. For an assurance engagement, the scope should include consideration of relevant systems, records, personnel, and physical properties.

Although the IAF and the client jointly establish the objectives of a consulting engagement, the IAF should determine that the scope of the engagement is sufficient to satisfy the agreed-upon procedures. If the IAF believes that the scope is not adequate, the IAF should discuss the issue with the client to determine whether to continue with the engagement.

Anecdotal evidence suggests that recent laws and regulations (e.g., Sarbanes-Oxley Act of 2002, NYSE listing requirements, Nasdaq listing requirements) will impact the scope of assurance and consulting engagements. For example, one OP indicated that management and the chair of the audit committee of one client were debating the scope of an assurance engagement. While the audit committee chair was asking for expanded coverage of controls over financial reporting, management was resisting because of insufficient resources.

Engagement Resource Allocation

Standard 2230 states that internal auditors should determine and have access to appropriate resources to achieve engagement objectives. Staffing should be based on an evaluation of the nature and complexity of each engagement, time constraints, and available resources. The organization's audit methodologies can affect needed resources. For example, Lindow and Race (2002) reported that the effective implementation of a "business risk" approach required hiring personnel with diverse backgrounds. Similarly, techniques such as CSA require special skills (Hubbard, 2000).

Engagement Work Program

Standard 2240 requires the IAF to develop and document work programs that achieve the engagement objectives. Work programs for assurance engagements should include the procedures for identifying, analyzing, evaluating, and recording information during the engagement. On the other hand, the content of work programs for consulting engagements may vary depending upon the nature of the engagement.

The relationship between the auditor's risk assessments and planned audit procedures is an important practice issue. Research on external auditors does not fully support a correlation between risk assessments and audit plans (Zimbelman, 1997; Mock and Wright, 1999; Wright and Bedard, 2000). Research is needed to explore the relations between internal auditors' sensitivity to fraud risk factors and their subsequent performance of auditing procedures (Church, McMillan, and Schneider, 2001).

Research Questions

- Who does the risk assessment? Management or the IAF?
- If the auditor performs the risk assessment, does management review the assessment? Does the auditor have the authority to advise the audit committee/board of directors if there is a disagreement?
- Are there substantive differences between the risk assessment processes of internal and outside providers?
- Do they (management, inside providers, or outside providers) get it right?
- How is risk assessment translated into an audit plan?
- What does management/audit committee/board of directors do about findings?
- To what extent does control self-assessment improve the efficiency and effectiveness of an internal audit?
- Is control self-assessment appropriate for all internal audits? Some internal audits? If so, what kind (size, industry, degree of cosourcing)?
- To whom will the CEO and the CFO turn for help when required to certify the accuracy of the financial statements: the chief audit executive (also referred to as the director of internal audit), the chief accounting officer (or controller), or the external auditor? If the CAE, what is the impact on the type and scope of internal audit engagements?

Performing the Engagement

When performing the engagement, the IAF must identify, analyze, evaluate, and record sufficient information to achieve the engagement's objectives.

Identifying Information

Standard 2310 requires the IAF to identify information that is sufficient, reliable, relevant, and useful. Although Practice Advisory 2310-1 describes these attributes, the *Standards* do not mandate specific types of information. Instead, professional judgment plays a large role

in answering the questions about how much and what kind of information should be gathered and analyzed during the engagement.

One technique used to identify and examine information is analytical procedures. According to Practice Advisory 2310-1, the application of analytical auditing procedures for identifying information to be examined is based on the premise that, in the absence of known conditions to the contrary, relationships among information may reasonably be expected to exist and continue. Examples of contrary conditions include unusual or nonrecurring transactions or events; changes in the company's strategic focus; accounting, organizational, operational, environment, and technological changes; inefficiencies; ineffectiveness; and errors, fraud, or illegal acts.

Another technique that is useful in identifying information is data mining. Kusnierz and Livsey (1999a) explain that this process is used to "identify patterns in immense quantities of apparently random data." The investigator uses the patterns to assess whether there are anomalies in an activity (for example, an unusual number of returns from a particular customer or an unusual number of checks being issued to a particular supplier). Kusnierz and Livsey also discuss Benford's law and the work of Dr. Mark Nigini in using statistics to discover fraud (see the February 1999 issue of *Internal Auditor* for more discussion of this).

David and Steinbart (2000) used a mail survey to obtain information about the status of data warehousing and data mining in various organizations and the role played by internal auditors in their organization's data warehousing and data mining efforts. Survey results showed that internal auditors do not extensively use their organizations' data warehouses. Less than one-half of internal auditors who worked in an organization with a data warehouse indicated that they used those warehouses. However, the majority of those who use their organization's warehouse indicated that such use improved audit quality and reduced the time to complete an audit. An interesting research issue would be the investigation of the use of data mining by IAFs with a risk-based as opposed to a more traditional internal auditing methodology. When asked about the use of data mining, one OP responded that the use of data mining was a "bottom up" approach that is inconsistent with "top down" approach of risk-based auditing.

Research Questions

- What is the relationship between the nature and sufficiency of audit evidence and the type of engagement (assurance vs. consulting)? Organization characteristics (size, industry, IAF skill set)?

- What is the relationship between the nature and sufficiency of audit evidence and the IAF's audit methodology (traditional vs. "business risk")?

- What is the relationship between the nature and sufficiency of audit evidence and the type of the report? The recipient (auditee, board, audit committee, regulators, others outside the scope of the report)?

- What is the level of interaction between the IAF and the external audit function? Is that level of interaction impacted by the degree of cosourcing?

Analysis and Evaluation

Standard 2320 requires the IAF to base conclusions and engagement results on appropriate analyses and evaluations. Analytical procedures and benchmarking are tools that can be used to assist the auditor in performing analyses.

According to Practice Advisory 2320-1, analytical auditing procedures should be used during the engagement to examine and evaluate information to support engagement results. The Practice Advisory provides six factors that the IAF should consider in determining the extent to which analytical procedures should be used. After evaluating these factors, the IAF should consider and use additional audit procedures based on the findings from the analytical procedures.

In understanding the use of benchmarking, several definitions of benchmarking are helpful:

- Simons (2000): "A technique used to calibrate an organization's efforts against a 'best of class' yardstick."

- Merchant (1998): "A process in which an organization studies other organizations' best practices and implements processes and systems to enhance its own performance."

- The Canadian Institute of Chartered Accountants (CICA): "Benchmarking is the established baseline for capturing performance measures relevant to …processes, systems, and organizations."

Simons discusses benchmarking as a method for comparing performance of an organization against performance by other like organizations as a way of enhancing understanding of that organization's performance. Care must be taken that similar information is being compared. It is important to understand the results of the benchmarking and properly use that information. Simply collecting it is not enough.

Merchant suggests that many aspects of an organization's operations can be benchmarked against those of other organizations. He indicates that some companies gather their own

benchmarking data while others form cooperative ventures and share data. The CICA has a partnership with several organizations that provide benchmarking data that allows members to access worldwide databases and benchmark more than 60 business processes. In our meetings with the practice leaders of the Big 4 accounting firms in Canada, several firms reported that they use benchmarking as a way of assessing a client's performance. One firm reported that they had invested heavily in a very large benchmarking database for so doing.

Whether benchmarking is used more in assurance on consulting engagements is an interesting question. Richards (2001) reports that from the IAF's perspective, consulting assignments provide many potential benefits, including greater use of benchmarking.

Research Questions

- What types of procedures (analytical procedures; data mining; nonfinancial measures-quantitative, qualitative) lead to efficient/effective auditing?

- To what extent does benchmarking improve the efficiency and effectiveness of an internal audit?

- Is benchmarking appropriate for all internal audits (traditional audit, operational audit, consulting engagement)? Some internal audits? If so, what kind (size, industry, degree of cosourcing)?

- To what extent does data mining improve the efficiency and effectiveness of an internal audit?

- Is data mining appropriate for all internal audits? Some internal audits? If so, what kind (size, industry, degree of cosourcing)?

- What is the role of judgment recognizing the varying perspectives (i.e., short-term vs. career and diverse background vs. traditional external audit background) for internal auditors?

Recording Information

According to *Standard 2330*, the IAF should record relevant information to support the conclusions and engagement results. The *Standards* require the chief audit executive to develop policies governing the retention of engagement records. This requirement is applicable to both assurance and consulting engagements. An interesting research question

is what is the impact of Sarbanes-Oxley on the IAF's document retention requirements? Sarbanes-Oxley requires that external auditors retain documents for seven years, but does not address internal auditors.

The *Standards* do not mandate specific types of documentation. Practice Advisory 2330-1 recognizes that the organization, design, and content of engagement working papers depend on the nature of the engagement and requires the chief audit executive to establish documentation policies for the various types of engagements performed. How the documentation requirements for an assurance versus a consulting engagement differ could be investigated.

Research Questions

- What is the relationship between types of evidence and documentation?
- What is sufficient documentation?
- Is the type of documentation different for assurance versus consulting engagements?
- Is the type of documentation different for inside providers versus outside providers?

Engagement Supervision

Engagements should be properly supervised to ensure objectives are achieved, quality is assured, and staff is developed *(Standard 2340)*. Although the chief audit executive has overall responsibility for review, experienced internal auditors may review the work of other less experienced internal auditors (Practice Advisory 2340-1). A fruitful area of research is the relationship between internal auditor characteristics (e.g., experience, background) and the effectiveness of the review process. Research shows a significant relationship between reviewer characteristics and review efficiency and effectiveness (Ballou, 2001; Bamber and Ramsay, 2000). See also Chapter 6 of this monograph for a discussion of controlling the IAF.

Research Questions

- Who is doing the supervision?
- What is the role of the chief audit executive — figurehead, follow up?

- Is the level and quality of supervision impacted by the organizational reporting structure of the IAF (e.g., is supervision different when IAF reports to the audit committee vs. when it reports to management)?

- Is the role of chief audit executive outsourced? If the engagement is cosourced 100 percent, to whom does the IAF report?

Communicating the Engagement Results

The *Standards* require the IAF to communicate engagement results promptly. The *Standards* set threshold requirements regarding the criteria for communications, the quality of communications, disclosure of noncompliance with the *Standards*, disseminating results, and monitoring progress. The form and content of communications vary among organizations and even within an organization. See Chapter 6 for a discussion of communication issues related to staffing and managing the IAF.

Criteria for Communicating

Standard 2410 states that communications should include certain criteria (the engagement's objectives, scope, and applicable conclusions, recommendations, and action plans). They do not prescribe or proscribe a standard format. Factors that determine format include the type of service (e.g., assurance, consulting), the nature of the activity reviewed (e.g., financial, nonfinancial), the kind of report (e.g., oral or written, interim or final, opinion or no opinion), and the recipient of the report (e.g., operational management, senior management, audit committee). Sawyer (1996) and Cutler (2001) provide valuable guidance about designing reports.

Because the objectives of an assurance engagement are different from the objectives of a consulting engagement, the format of a report for an assurance engagement will be different from the format of a report for a consulting engagement. Cutler (2001) predicted that consulting reports will become more common in response to The IIA's new *Standards* and provided an overview of the standard components of a report for consulting engagements.

The *Standards* permit both written communications (reports) and oral communications (briefings). For example, the IAF may issue reports for assurance engagements, but use briefings for consulting engagements. Briefings may be supplemented with visual aids such as PowerPoint slides. Raaum and Morgan (2001) discuss various communication tools, including two types of reports — letter and chapter reports — as well as briefings.

Audit results (i.e., findings, issues) are a key component of audit communications. There are different ways to present the key issues. Hubbard (2001) describes two approaches. The five-attributes approach covers five points — criteria, condition, cause, effect, and recommendation. The risk-based approach responds to the current trend of "business risk" auditing.

Who the IAF reports to can influence the form and content of the audit report. For example, in the 1990s, Whirlpool redesigned its audit reports to incorporate a user focus. The reports were divided into three sections: executive summary, key issues, and other opportunities. The key issues and the executive summary sections were distributed to senior management. Functional management received all three sections (Gray and Gray 1996, 135).

Research Questions

- Should the IAF have to render an audit opinion?
- What is the potential effectiveness of internal auditor reports vs. external audit reports? As an example, there has been increased demand for internal auditors to provide assurances on the reliability of systems used for processing data for third parties because the third-party users do not find significant value in the typical SAS No. 70 review performance by CPAs.
- Another example is the requirement of management under Sarbanes-Oxley to report on internal control. What role does/can the IAF play in aiding management in fulfilling its legal responsibility?

Quality of Communications

Standard 2420 requires that the communications meet various elements of quality (accurate, objective, clear, concise, constructive, complete, timely). The IAF uses a variety of tools (e.g., narrative, symbols, exhibits, tables, and pictures) to achieve "quality" communications. For example, some IAFs use the stoplight icon method for organizing the report and highlighting critical areas of risk. Within the report, a traffic light symbol accompanies the summary write-up of each audit area. Under this method, a green light indicates that an area is acceptably controlled, a yellow light suggests that minor improvements are needed, and a red light draws attention to risks that are unacceptably controlled (IIA www.theiia.org/ecm/printfriendly.cfm?doc_id=1493).

As part of their total quality management (TQM) efforts in the 1990s, some companies improved the quality of their communications. Southern California Edison Company implemented a quality evaluation form for draft audit reports. Audit mangers used the form to rate the quality of 12 attributes of draft audit reports. After three years, managers reported that the quality of outgoing reports was steadily improving (Gray and Gray, 1996, 101). TRW Inc. revamped its audit report processes as well. As a result, the average time between the exit conference and the final audit report dropped from 88 days to five days (Gray and Gray, 1996, 135).

What constitutes quality communications may change over time. According to Cutler (2001), " . . . if you're still using the same report that you were using five years ago, chances are you're providing more information than your readers want. You've got to look at conveying messages without overloading the readers with information."

Globalization can affect the quality of communications. For example, after Whirlpool expanded operations into foreign countries, the IAF found it necessary to change its five opinion categories (excellent, good, satisfactory except for, unsatisfactory, and unacceptable). The IAF found that the labels for the categories carried different meanings in different cultures. That is, an "unacceptable" rating in an Asian environment was interpreted quite differently from that same rating in a Western environment. As a result, the IAF changed to three opinion categories (meets Whirlpool's expected design, requires improvement to meet Whirlpool's expected design, needs immediate attention) (Gray and Gray, 1996, 135).

Noncompliance with the Standards

IAFs are encouraged to report that their activities are "conducted in accordance with the *Standards for the Professional Practice of Internal Auditing*" *(Standard 1330)*. If the IAF does not comply with the *Standards* on a particular engagement, the *Standards* require the communications disclose the standard not achieved, the reason for noncompliance, and the impact of noncompliance *(Standard 2430)*.

Research Questions

- Are internal auditor reports oral or written? What factors determine whether the report is oral or written?

- How can the IAF more effectively communicate?

- Does including the auditee's responses to findings in the final communication have an effect on the extent to which the auditee responds to the findings?

Disseminating Results

Technology has impacted and will continue to impact the dissemination of audit results. For example, in the 1990s Southern New England Telecommunications' IAF began providing weekly updates by voice mail and written feedback through a matrix, rather than relying on the audit report as the primary means of communications with management (Gray and Gray, 1996). Cutler (2001) predicts that more reports will be delivered electronically or through a Web interface and that audit reporting will increasingly incorporate multimedia approaches.

Research Questions

- To whom does the IAF (internal or outsourced) report?
- Does the IAF report to/have a line of communication to the audit committee?
- Is there follow-up? If so, to whom are results of follow-up reported?
- Does the fact that some or all of the audit is cosourced affect the extent of follow-up?
- Does the type of engagement affect the extent of follow-up?

V. Summary

The chapter considers the IAF process in the context of changes that are taking place in the audit approach, the focus on knowledge of the business, and the business risks facing the organization of both internal and external auditors. Next, a model for considering the IAF in a three-dimensional space (engagement type, degree of cosourcing, and organization characteristic) is suggested as a structure for analyzing the IAF process. Finally, the internal audit process — planning the engagement, performing the engagement, and communicating the engagement results — is discussed. Appendix I summarizes the research questions suggested based on the material in the chapter. We believe that research designed to answer these questions and extensions of them will allow the practice of internal auditing to move forward.

VI. Appendix I: Chapter Research Questions

Recent Changes in Internal and External Auditing

- Is the convergence suggested by Rittenberg and Covaleski in their 1997 report continuing or was it an artifact of the organizations they interviewed?
- What, if any, impact have recent financial debacles such as Enron and WorldCom had on changes in the internal auditing approach suggested by Rittenberg and Covaleski?
- Is the IAF moving in the same direction as Lemon, Tatum, and Turley suggested the external auditing profession was moving?

The Model

- Does the model reflect reality? Can internal auditing be so categorized? Do these three dimensions capture the necessary components for a discussion of internal auditing's systematic, disciplined process?
- Assuming the model does reflect reality, do internal audits differ across all three dimensions? If so, how?
- Are there substantive differences between the engagements performed by internal and outside providers? Is the extent of cosourcing a factor?
- Is there a difference in engagement type across different industries?
- Do organizations migrate from a traditional audit to an operational audit and from an operational audit to a consulting engagement? If they do, what causes the migration?
- Do organizations migrate from an operational audit to a traditional audit? If they do, what causes the migration?
- Do organizations migrate along the cosource continuum? If so, what causes the migration?
- How are costs and benefits assessed both ex ante and ex poste in the decision to migrate to greater cosourcing?

- What is the role of organizational culture in determining: (a) Whether the IAF is performed by an internal or outside provider? (b) The degree of cosourcing if an outside provider is used? (c) Whether a traditional audit or operational audit or consulting engagement is appropriate?

- Is there a correlation between the level of cosourcing and the migration from traditional audit to operational audit to consulting engagement?

- What is the role (mandate) of internal auditing in the organization? Management training or internal auditing. How does this role influence the degree of cosourcing and the engagement type?

- The New York Stock Exchange has proposed that all companies be required to have a functioning IAF as a condition of listing. What are the implications for degree of cosourcing and types of engagements?

- The Sarbanes-Oxley Act of 2002 prohibits the external auditor from performing certain activities, including internal audit outsourcing. What are the effects on outsourcing?

Planning the Engagement

- Who does the risk assessment? Management or the IAF?

- If the auditor performs the risk assessment, does management review the assessment? Does the auditor have the authority to advise the audit committee/board of directors if there is a disagreement?

- Are there substantive differences between the risk assessment processes of internal and outside providers?

- Do they (management, inside providers, or outside providers) get it right?

- How is risk assessment translated into an audit plan?

- What does management/audit committee/board of directors do about findings?

- To what extent does control self-assessment improve the efficiency and effectiveness of an internal audit?

- Is control self-assessment appropriate for all internal audits? Some internal audits? If so, what kind (size, industry, degree of cosourcing)?

- To whom will the CEO and the CFO turn for help when required to certify the accuracy of the financial statements — the chief audit executive (also referred to as the director of internal audit), the chief accounting officer (or controller), or the external auditor? If the CAE, what is the impact on the type and scope of internal audit engagements?

Performing the Engagement: Identifying Information

- What is the relationship between the nature and sufficiency of audit evidence and the type of engagement (assurance vs. consulting)? Organization characteristics (size, industry, IAF skill set)?

- What is the relationship between the nature and sufficiency of audit evidence and the IAF's audit methodology (traditional vs. "business risk")?

- What is the relationship between the nature and sufficiency of audit evidence and the type of the report? The recipient (auditee, board, audit committee, regulators, others outside the scope of the report)?

- What is the level of interaction between the IAF and the external audit function? Is that level of interaction impacted by the degree of cosourcing?

Performing the Engagement: Analysis and Evaluation

- What types of procedures (analytical procedures, data mining, nonfinancial measures-quantitative, qualitative) lead to efficient/effective auditing?

- To what extent does benchmarking improve the efficiency and effectiveness of an internal audit?

- Is benchmarking appropriate for all internal audits (traditional audit, operational audit, consulting engagement)? Some internal audits? If so, what kind (size, industry, degree of cosourcing)?

- To what extent does data mining improve the efficiency and effectiveness of an internal audit?
- Is data mining appropriate for all internal audits? Some internal audits? If so, what kind (size, industry, degree of cosourcing)?
- What is the role of judgment recognizing the varying perspectives (i.e., short-term vs. career and diverse background vs. traditional external audit background) for internal auditors?

Performing the Engagement: Recording Information

- What is the relationship between types of evidence and documentation?
- What is sufficient documentation?
- Is the type of documentation different for assurance versus consulting engagements?
- Is the type of documentation different for inside providers versus outside providers?

Performing the Engagement: Engagement Supervision

- Who is doing the supervision?
- What is the role of the chief audit executive — figurehead, follow-up?
- Is the level and quality of supervision impacted by the organizational reporting structure of the IAF (e.g., is supervision different when IAF reports to the audit committee vs. when it reports to management)?
- Is the role of chief audit executive outsourced? If the engagement is cosourced 100 percent, to whom does the IAF report?

Communicating Engagement Results: Criteria for Communicating

- Should the IAF have to render an audit opinion?
- What is the potential effectiveness of internal auditor reports vs. external audit reports? As an example, there has been increased demand for internal auditors to provide assurances on the reliability of systems used for processing data for third parties because the third-party users do not find significant value in the typical SAS No. 70 review performance by CPAs.
- Another example is the requirement of management under Sarbanes-Oxley to report on internal control. What role does/can the IAF play in aiding management in fulfilling its legal responsibility?

Communicating Engagement Results: Quality of Communications

- Are internal auditor reports oral or written? What factors determine whether the report is oral or written?
- How can the IAF more effectively communicate?
- Does including the auditee's responses to findings in the final communication have an effect on the extent to which the auditee responds to the findings?

Communicating Engagement Results: Disseminating Results and Monitoring

- To whom does the IAF (internal or outsourced) report?
- Does the IAF report to/have a line of communication to the audit committee?
- Is there follow-up? If so, to whom are results of follow-up reported?
- Does the fact that some or all of the audit is cosourced effect the extent of follow-up?
- Does the type of engagement affect the extent of follow-up?

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