# Chapter 7

## Internal Audit

### Chapter learning objectives:

<table>
<thead>
<tr>
<th>Lead</th>
<th>Component</th>
<th>Indicative syllabus content</th>
</tr>
</thead>
</table>
| C1: Internal controls systems. | (a) Discuss roles and responsibilities for internal controls.  
(b) Discuss the purpose of internal control.  
(c) Analyse the features of internal control systems. | • Role of risk manager as distinct from internal auditor  
• Control systems in functional areas  
• Operational features of internal control |
| C3: Internal audit in organisations. | (a) Discuss forms of internal audit.  
(b) Discuss internal audit process.  
(c) Discuss effective internal audit.  
(d) Discuss the internal audit report | • Compliance audit, fraud investigation, value for money audit and management audit  
• Operation of internal audit  
• Assessment of audit risk  
• Process of analytical review  
• Independence, staffing and resourcing of internal audit  
• Preparation and interpretation of internal audit reports |
1. Management review of controls

The UK’s Turnbull Committee requires that a review of internal controls be an essential part of the management’s role. This involves considering the risks facing the organisation and the controls in place to manage those risks.

The organisation may employ an internal audit department to monitor internal control.

What Is Internal Audit (IA)?

**Internal audit** is a monitoring or appraisal activity established by management and directors for the review of the accounting and internal control systems as a service to the entity. It functions by, amongst other things, examining, evaluating and reporting to management and the directors on the adequacy and effectiveness of the accounting and internal control systems. - Auditing Practices Board

- An independent and objective assurance activity, enhancing the organisation’s activities by recommending improvements based on analysis and assessment of data and business processes.
- Internal auditing provides value to governing bodies and senior management as an objective source of independent advice.
- The scope of IA is very wide and depends on the organisation. It could be anything from efficacy of operations to reliability of financial reporting, investigating fraud and compliance reviews.

Risk management vs. Internal audit

<table>
<thead>
<tr>
<th>Risk management:</th>
<th>Internal Audit:</th>
</tr>
</thead>
<tbody>
<tr>
<td>The risk management team would be ultimately responsible for identification, assessment and prioritisation of risks, as well as establishing the internal controls to manage those risks.</td>
<td>Monitors and reviews the controls in place.</td>
</tr>
<tr>
<td>The team would form a risk response strategy for all areas of the business.</td>
<td>Testing and evaluation of risk controls (those that design controls should not test them - independent approach).</td>
</tr>
<tr>
<td>Risk staff would provide training to the operational managers to help them identify risks in their area of business and determine controls.</td>
<td>Carrying out special investigations and Value for Money (VFM) audits to ensure efficient use of resources.</td>
</tr>
<tr>
<td></td>
<td>Assisting the senior management in various other projects.</td>
</tr>
<tr>
<td>Risk management:</td>
<td>Internal Audit:</td>
</tr>
<tr>
<td>-----------------</td>
<td>----------------</td>
</tr>
<tr>
<td>Due to their extensive knowledge of the business, may be required to assist in identifying risks.</td>
<td></td>
</tr>
</tbody>
</table>

**External audit** - a periodic examination of the books of account and records of an entity carried out by an independent third party (the auditor), to ensure that they have been properly maintained, are accurate and comply with established concepts, principles, accounting standards and legal requirements and give a true and fair view of the financial state of the entity.

The three parties involved in the process review are:

- **Risk management** – identifies risk.
- **Managers** – determine controls to tackle those risks.
- **Internal auditors** – assess the controls.

**Factors affecting the need for Internal Audit**

- Scale, diversity and complexity of the company’s operations.
- Number of employees.
- Cost/benefit considerations.
- Changes in the organisational structures, reporting processes or underlying information systems.
- Changes in key risks.
- Problems with the existing internal control system.
- An increased number of unexplained or unacceptable events.

In the absence of an internal audit department, the Turnbull Report requires listed companies to review the need for an internal audit function annually.
2. **Scope and Standards of Internal Audit Work**

**Scope**

The scope will be specified by the management, but will generally include:

- Reviewing and reporting on the appropriateness and effectiveness of accounting and internal controls.
- Reviewing financial and operating information for accuracy and timely reporting.
- Performing Value for Money (VFM) audits to evaluate the economy, effectiveness and efficiency of operations.
- Ensuring compliance with applicable laws and regulations.
- Conducting special investigations such as investigating suspected fraud.
- Assisting in identifying significant risks, both internal and external.
- Assisting the external auditors with their audit work and providing them with information.
- Assessing governance procedures and compliance with corporate governance codes.

**Standard of internal audit work**

The Internal Auditing Standards Board (IASB) of the Institute of Internal Auditors have issued international standards for internal audit, which include:

- **Attribute Standards** that define the characteristics of the organisation and internal auditors.
- **Performance Standards** that define the nature and quality criteria of the internal auditing activities.

**Attribute standards for internal audit:**

- **Independence** - to ensure independence, the audit department should report to an appropriate level such as the audit committee.
- **Objectivity** - auditors should avoid conflict of interest or bias influencing their work.
- **Professional care**.

**Performance standards for internal audit**

- **Managing internal audit** – the audit should be well planned, organised, supervised, and reviewed. The process should be well documented.
- **Risk management** – risky areas should be identified.
• **Control** – effectiveness and efficiency of internal control should be assessed and recommendations given accordingly.

• **Governance** – the company’s system of corporate governance should be evaluated, and improvements should be recommended.

• **Communicating results** – the results should be reported accurately and in a timely manner.

3. **Structure, Independence and Effectiveness of Audit**

Internal auditors may face conflicts of interest or threats to independence. Measures should be taken to protect their independence.

**Measures to protect IA independence:**

• The internal auditors should be independent of the executive management and the activities they audit.

• The department should report to a senior director or the audit committee.

• The head of the internal audit committee should have direct access to the chairman and the audit committee.

• Approval for the appointment and termination of the head of internal audit should be obtained from the audit committee.

**Outsourcing Internal Audit**

Some companies may outsource their internal audit function.

<table>
<thead>
<tr>
<th>Advantages of Outsourcing IA</th>
<th>Disadvantages of Outsourcing IA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time spent in administering an in-house internal audit department is saved</td>
<td>Independence affected if provided by external audit</td>
</tr>
<tr>
<td>Greater access to new technology and specialist skills</td>
<td>Possible lack of knowledge and understanding of the business</td>
</tr>
<tr>
<td>Enhanced independence</td>
<td>Flexibility and availability not as high as with an in-house audit department</td>
</tr>
<tr>
<td>Cost relating to permanent staff avoided</td>
<td>Lack of control over standard of service</td>
</tr>
<tr>
<td>Risk of staff turnover shifted to the outsourcing firm</td>
<td></td>
</tr>
<tr>
<td>Cost and efficiency of the internal audit function may be improved</td>
<td></td>
</tr>
</tbody>
</table>
Evaluating the effectiveness and efficiency of internal audit

Efficiency can be measured by comparing actual costs with target costs and effectiveness by identifying improvements in internal control.

Audit report

The IA report should include:

- executive summary on the front page - 1st section
- scope of the assignment - 2nd section
- observations and recommendations - 3rd section
- recommendations graded by importance (preferably with due dates and responsible personnel)
- statement of responsibility for audit (they test on a sample basis - IA cannot test everything)

4. Internal and External Audit

<table>
<thead>
<tr>
<th></th>
<th>Internal Audit (IA)</th>
<th>External Audit (EA)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Required by</td>
<td>Directors and shareholders</td>
<td>Statute for limited companies</td>
</tr>
<tr>
<td>Appointed by</td>
<td>Directors</td>
<td>Shareholders or directors</td>
</tr>
<tr>
<td>Reporting</td>
<td>Directors</td>
<td>Shareholders</td>
</tr>
<tr>
<td>Scope of assignment</td>
<td>Work relates to the operations of the organisation, mainly controls</td>
<td>Financial statements</td>
</tr>
<tr>
<td>Opinion</td>
<td>True and fair view and proper presentation</td>
<td>Adequacy of Internal Control System (ICS)</td>
</tr>
<tr>
<td>Relationship with the organisation</td>
<td>Mostly employees of the organisation unless outsourced</td>
<td>Independent of the company</td>
</tr>
</tbody>
</table>

Relationship of IA to EA

External auditors may rely on the work performed by the internal auditors.

Factors to consider when relying on the work of internal audit:

- The status of the internal audit department within the organisation.
- The scope of the internal audit function.
- Whether the recommendations of the internal auditor are acted upon.
• Technical competence of the internal auditors.
• Whether the work of the internal audit department is properly planned, supervised, reviewed and documented.
• What areas of the external audit program have been covered by internal audit.
• Whether the tests performed by the internal auditors meet the requirements of the external auditors with regards to scope and quality.

**Benefit:** This sharing of work can result in a reduced audit fee.

**Management Letter**

The management letter is a by-product of an audit that lists the control issues found during the audit.

The letter will include:

• Control weaknesses
• Recommendations to mitigate those weaknesses

**Fraud investigations**

Different perspectives on fraud:

<table>
<thead>
<tr>
<th>External Audit</th>
<th>Internal Audit</th>
<th>Board of directors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Responsible for identifying material misstatements in the financial statements in order to ensure that they give a true and fair view.</td>
<td>IA has a duty to report ANY fraud if they spot anything during the course of audit.</td>
<td>Responsible for detecting and preventing fraud.</td>
</tr>
<tr>
<td>Responsible for detecting ONLY <strong>material</strong> fraud.</td>
<td>IA could perform a follow-up audit after a fraud has been discovered.</td>
<td></td>
</tr>
<tr>
<td>If immaterial fraud is detected, it must be reported to those charged with governance (no particular responsibility to detect it).</td>
<td>Evaluate the likelihood of fraud occurring.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Assess the consequences of a detected fraud.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Make recommendations on how to prevent fraud.</td>
<td></td>
</tr>
</tbody>
</table>
5. Types of Internal Audit Assignment

Compliance Audit
An audit that confirms that the organisation’s activities and systems are in compliance with laws, regulations, written rules and internal procedures.

Transactions Audit
An audit that verifies individual transactions by matching them against source documents.

Risk-Based Audit
Risk-based audit tests systems based on the level of risk attached.
The auditor assesses risk in different areas of the business and directs their focus to the more risky areas.

Quality Audit
A quality audit will establish whether quality objectives are being met.
It will determine the appropriateness and effectiveness of the quality standards and review actual performance against those standards.

Post-Completion Audit (Post-Completion Review)
The post-completion audit is performed after the completion of a project/process and gives feedback on the success of the project.
The audit usually evaluates a project based on three criteria:

• Time – was the project completed on time?
• Cost – was the project completed within budget?
• Quality – did the project solve the original issue successfully, thus delivering the expected quality?

Value for Money Audit

**Value for money audit:** A value for money audit is an investigation into whether proper arrangements have been made for securing economy, efficiency and effectiveness in the use of resources. - CIMA

A value for money audit measures three main areas:

• **Economy** means to obtain resources to be input to the business at the lowest cost possible while ensuring that the quality is not compromised.
• **Efficiency** assesses the quantity and quality of the output achieved with the minimum amount of resources.

  Efficiency is measured as:

  • Maximising the output for a given amount of input.
  • Achieving a given quantity of output from the minimum resources possible.

• **Effectiveness** is when a system or an activity achieves its intended objectives.

**Problems with VFM Audits**

• It might prove difficult to measure outputs.

• It might be difficult to determine the objectives of an activity.

• The focus must either be on economy and efficiency OR on effectiveness.

• When assessing economy and efficiency, quality could be overlooked.

**Environmental Audit**

**Environmental audit:** A management tool comprising a systematic, documented, periodic and objective evaluation of how well organisations, management and equipment are performing, with the aim of contributing to safeguarding the environment by facilitating management control of environmental practices and assessing compliance with company policies, which would include meeting regulatory requirements and standards. - CIMA

An environmental audit may be undertaken to obtain or maintain ISO 14001.

Such audits will normally involve assessing:

• The organisation’s impact on the environment in terms of sustainability and emissions.

• Whether targets set are being achieved.

• Whether the company is complying with applicable standards, laws and regulation.

• Whether the organisation is reporting its environmental activities with truth and fairness.

**Social Audit**

A social audit measures a company’s contribution to society in the form of donations, sustainable use of resources, complying with health and safety regulations, providing equal opportunities, etc.
Management Audit (Operational Audit)

**Management audit:** An objective and independent appraisal of the effectiveness of managers and the corporate structure in the achievement of the entity’s objectives and policies. Its aim is to identify existing and potential management weakness and recommend ways to rectify the weakness. - CIMA

A non-routine investigation that looks into all the aspects of management performance. Management audits may include a review of resource utilisation, workloads, policies and procedures and competence, or analysis of costs.

**Systems audit**

A systems-based audit aims to identify weaknesses in a system of internal controls. Greater focus on systems with greater risk. Assurance given in systems audit is:

- On the design of the internal control systems (ICS) – whether they are meeting the objectives set.
- On the reliability and effectiveness of the internal ICS.

### 6. The Internal Audit Process

[Diagram showing the audit process]

- **Start**
- **Plan the audit**
- **Find out about systems and controls**
- **Test compliance with controls**
- **Assess if controls are adequate**
- **Confirm the operation of the system**
- **Test application of controls**
- **Review, report and recommend**
- **Agree on objectives**
7. Audit Planning

An audit programme should be established for each financial year. Planning will involve:

- Determining the objectives of the audit.
- Assessing the resources and time required for the audit.
- Ascertaining the areas to investigate.
- Making decisions about the evidence to be collected and recorded.
- Assessing how much time and effort will be required for the audit.

Risk-based approach

Most commonly used now.

A risk-based approach determines areas with high risk and concentrates efforts in those areas.

**Benchmarking** is a method that auditors can use to identify risk. Benchmarking involves comparing business units with other business units, competitors or best practice.

**Types of benchmarking:**

- Process benchmarking (focused on business processes).
- Product benchmarking (focused on designing new products or upgrading existing ones).
- Functional benchmarking (focused on a single business function).
- Competitor benchmarking.
- Environmental benchmarking (collecting and analysing the environmental performance of comparable activities between or within the entities).

Annual audit plan and risk analysis

The auditor will assess inherent risk and the quality of controls to decide on areas to audit, giving greater importance to areas with higher inherent risk and low control quality.

Audit risk is the risk that the auditor will give an incorrect opinion on the activities audited.

**Audit risk has three components:**

- **Inherent risk** is the risk associated with an activity irrespective of the quality of related controls or the effectiveness of the management.
• **Control risk** is the risk that the existing controls are inadequate, inappropriate or ineffective.

• **Detection risk** is the risk that the auditor may not be able to detect problems or weaknesses within an operation.

**Materiality**

An item is material if its omission or misstatement affects the decision of the user of the financial statements.

Materiality can be quantitative or qualitative in nature.

### 8. Systems Investigation and Documentation

The auditor must document the whole process of audit including the systems and their findings on the system.

Ways to investigate the systems:

1. **Flowcharts** present information in an understandable manner to help identify weaknesses.

2. **Interviews/questionnaires** can be used to gather information and identify key controls.

3. **Systems documentation** can be read to learn how the system should to operate.

4. **Observation** of the system in operation.

### 9. Control Assessment

After ascertaining the controls in place, the auditors will assess their effectiveness in fulfilling their objectives.

### 10. Audit Testing

**Types of testing**

- **Compliance Testing** (*test of controls*): the controls will be tested to ensure that they are adequate and effective.

- **Substantive Testing** (*test of balances or transactions*): substantive testing examines the output and compares it to the expected output. It involves testing account balances and transactions on a sample basis.
11. Audit Sampling

Audit sampling is the application of audit procedures to less than 100% of the items within an account balance or a class of transaction in such a way that all sampling units have a chance of selection. This enables the auditor to form an opinion on the population based on the evidence obtained.

- **Sampling risk**: is the risk that the auditor’s opinion would have been different had the whole population been subjected to audit testing.

- **Non-sampling risk**: is the risk that the auditor may reach an incorrect opinion from applying inappropriate procedures or any other reasons not related to sampling risk.

12. Analytical review

Analytical review is an audit procedure that examines trends and ratios to identify any abnormalities.

**Ratios:**

- **Profitability ratios**: gross profit % and net profit %.
- **Efficiency ratios**: receivable days, inventory days and payables days.
- **Liquidity ratios**: current ratio, quick ratio, interest cover, debt ratio and gearing ratio.
- **Return**: return on capital employed (ROCE).

Comparisons can be made with:

- Prior period
- Budgets/anticipated results
- Auditor estimates
- Similar organisations

**Use of analytical review**

- **Planning stage**: at the planning stage, analytical review will help to identify potentially risky areas.

- **Substantive testing**: analytical review can be used as a substantive procedure in various areas to obtain evidence.

- **Overall review**: at the overall review stage, analytical procedures will allow the auditor to conclude whether the activities being audited are consistent with the expected results and the auditor’s understanding of the system.
13. Audit Reporting

An internal audit report has no specified structure. However, it will normally include the following elements:

**Objectives of the audit work:**
- A summary of the audit process
- The results of the tests performed
- Audit opinion (if required)
- Recommendations
- A statement of responsibility

The internal auditor should carry out a post-implementation review to ensure that the recommendations have been carried out.

14. Audit of Computer Systems

Computer systems need to be tested to confirm that they are working correctly and producing reliable information.

Problems related to auditing computer systems:
- Controls being concentrated in the IT department.
- A lack of records relating to origination of transactions and updating of files.
- Encoded data.
- Lack of audit trail.
- Data may be overwritten during the year.
- Testing program controls.

**Audit approach**

There are two approaches to computer auditing:

1. **Around the computer:** this approach matches inputs to the expected outputs to determine whether the system is working correctly.

   This approach can only be adopted if:
   - The system is uncomplicated.
   - There is a visible audit trail.
• Systems documentation is easily available.

Problems with around the computer auditing:

• Computer files and programs are not tested, so there is no assurance that the system is operating as documented.
• It would be difficult to determine the source/cause of error.

2. **Through the computer**: in this approach the auditor will test the actual controls within the programs and interrogate the files.

This approach uses computer assisted audit techniques (CAATs).

### 15. CAATs

CAATS - computer assisted audit techniques (CAATs).

- **Audit software**: these are computer programs that are used to test the files of clients, e.g. ACL.

- **Test data**: this is data that is entered into the client’s computer system to test the controls. It includes:
  - *Live data*: data that is processed during a normal production run.
  - *Dead data*: data processed outside the normal cycle.
  - *Valid and invalid data*.

Risks related to test data:

• It may corrupt the system if not properly removed.
• System down time if dead data is used.
• It only tests the system at a particular point in time.
• Auditors are only testing programs and controls they know of.

<table>
<thead>
<tr>
<th>Advantages of CAATS</th>
<th>Disadvantages of CAATs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large amounts of data can be tested quickly and accurately</td>
<td>If the company system is not well-integrated, their use will be limited</td>
</tr>
<tr>
<td>CAATs test original documentation instead of printouts</td>
<td>Time-consuming to design tests for CAATs</td>
</tr>
<tr>
<td>Cost-effective</td>
<td>Costly if the system is bespoke because of high setup costs</td>
</tr>
</tbody>
</table>
## Advantages of CAATS

Greater assurance by comparing results from CAATs to traditional audit tests

## Disadvantages of CAATs

Unavailability of system documentation may cause problems in understanding the system

If there is a change in accounting year, the audit software will have to be redesigned

## Embedded audit facilities

Audit facilities may be embedded into computer programs for a continuous review of data and its collection.

### 16. Chapter Summary