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# **INTERNAL AUDITING**

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**In a Changing Management Culture**

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## **Foreword**

When we complete our government-wide review of internal audit in 1993, we will find that changes have taken place since 1984, when the Office last audited the function. Just how much, and in what respects, will become clearer as the audit unfolds.

As a preliminary to our review, we decided to do a survey that would help us assess what is happening in federal government internal audit units as compared to some of the best units elsewhere. You will be encouraged and stimulated as you read about the extent to which many of the audit units we talked to have advanced the philosophy, technical practice and status of internal auditing in their respective organizations.

We hope that you will see yourselves reflected in some of the "best practices" described in this report, and that you will see the possibilities for strengthening the internal audit function in your own organization.

We would very much like to thank the people in some 40 private sector companies and government departments who took time from their busy schedules to meet with the members of the study team. They contributed their knowledge of state-of-the-art internal auditing practices and gave us the feedback and advice we needed to complete this study.

L. Denis Desautels, FCA  
Auditor General of Canada

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## **EXECUTIVE SUMMARY**

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This study is based on a survey of internal audit in 40 government and private sector organizations in Canada and the United States. Our objective in carrying out the study was to document and describe the best of what we found and to provide a benchmark for internal audit in other organizations. We also wanted to alert senior management to the role that internal audit can and should be playing in federal government departments.

The study is particularly relevant, we feel, because of the velocity of changes that are taking place in many private and public sector organizations. These include a new emphasis on providing better service, eliminating activities that yield only marginal benefits, decentralizing authority, and shifting responsibility for control to operating units. These changes mean that internal control is more important than ever before. And since that control is migrating from the centre to the field, the type of internal control that is needed and where controls should be installed are of critical importance. Many organizations define control as encompassing everything an organization does to meet its business objectives. Accordingly, the sphere of internal audit is widening to include virtually all areas of activity. No longer is it concerned mainly with assessing the integrity of financial controls.

The people we interviewed for this study made it clear that the continuing relevance of internal audit was directly related to its ability to adapt to cultural change and broaden its horizons. Successful internal audit units have had to align their own philosophies and activities to parallel the changes taking place in their organization.

### **Internal audit is changing — a trend toward “value-added” audits**

Internal audit practice is moving away from merely reporting control deficiencies to management, a role that has traditionally had the potential for confrontation. Progressive heads of internal audit units now see the auditee as another “customer” for the audit. They are focussing on providing a cost-effective, useful service that the customer needs.



Audits are becoming more *cost-effective* by being "risk-driven". In many organizations that we visited, risk assessment is a continuous process that allows audit management to make "smarter" decisions about where to spend scarce audit dollars. Increasingly sophisticated risk-assessment techniques are helping auditors to determine where the areas of greatest risk lie in the organization.

Auditors spend more time auditing at the design stage of programs and systems in order to identify risks at an early stage rather than report problems after they have damaged the organization. Also they share knowledge and audit tools with management which encourages and assists in control self-evaluation by operating units.

Audits are becoming more *useful* because they are oriented to identifying problems, working with management to solve them, providing overall ratings on the adequacy of controls and finding new and better ways to do things.

The audit units that we talked to during the study were most concerned about the *quality* of their audits. All had developed ways of measuring their performance. The best are asking the auditee for feedback on audits through surveys. They are benchmarking with colleagues from other organizations and identifying and adopting best practices for use in their own units. Many had set up performance targets for measurable parts of the audit process, including the time for completing major phases of the audit, the time between finishing the audit and issuing the report, and so on. The result: better audits and better service to all concerned.

### **Visible support from senior management — an essential element**

It is clear that internal audit will be what senior management wants it to be. The audit units that we interviewed stressed that senior management must clearly signal to the rest of the organization that it supports internal audit. One signal is giving internal audit easy access to senior management and the audit committee. A number of organizations have identified the importance of internal audit in policy statements that they distribute to all employees. A high level of overt support fosters a parallel respect for the function from operating managers.

## **Internal audit — a place for the best and brightest**

The best organizations in the private sector use internal audit as a training ground for developing future leaders. Career internal auditors are the exception, rather than the rule in these organizations. They recruit high-potential people from either inside or outside the organization who spend two to four years getting a bird's-eye view of operations and then move on to the next step on their career path. We found that some provincial and state governments were adopting the same philosophy and were tending to have fewer career auditors.

## **Technology — internal audit's response**

Many businesses are becoming more technologically sophisticated. Recognizing that information and information technology are critically important to management, some internal audit units have developed software for continuously monitoring their organization's data on-line. This ability to keep a finger on the pulse of the organization is especially valuable when operations are decentralized or geographically dispersed.

EDP auditing is no longer the preserve of a small group of EDP specialists. The audit units we interviewed are developing EDP audit expertise for all staff. Most units are working to integrate the work of financial, operational and EDP auditors.

Computer-based tools for planning and managing audits are increasing audit quality and productivity. For example, instant, on-line communication allows audit managers to review the audit team's work during the course of the audit without leaving the office.

## **Reporting the audit results — a more constructive approach**

With the new service orientation that is growing in many internal audit groups, audit reports are being seen as constructive vehicles for encouraging managers to make cost-effective changes. The approach to reporting is becoming more co-operative; managers and auditors are working together to find solutions to problems during the course of the audit. Increasingly, audit reports are being recognized for what they are-- timely communication tools that should provide appropriate information at an adequate level of detail to the operational managers who are in a position to fix a problem and to senior managers who are responsible for ensuring that the problem does, indeed, get fixed.

## **Future trends**

The people with whom we talked during our study offered many ideas about the direction that internal audit would take in future. These points surfaced consistently in our interviews:

- Internal auditing is becoming more service-oriented, pro-active and preventive in focus.
- Better technology and more focussed audits will demand more expertise but fewer auditors.
- The collaboration between auditor and management will continue, and the auditor will act as advisor and counsellor on control matters.
- Internal audit will need to develop the ability to audit environmental issues.

# **PART I**

---

## **BACKGROUND AND STUDY OBJECTIVES**

The Office of the Auditor General plans to carry out a government-wide audit of internal audit and publish the results in the 1993 Annual Report. We last reviewed internal audit in 1984. Since that time, organizations in both the public and private sectors have had to adapt to significant change. For example, today's global marketplace and increased competitiveness have meant that in order to survive, many organizations have had to become more customer-focussed, change their corporate cultures and become more productive. Given these facts, we felt that we had to do some groundwork before we actually started our audit to see what these organizational changes have meant for internal audit. Specifically, we wanted to understand whether change had prompted organizations to rethink their audit requirements and processes. To find out, we launched this study. It had three objectives:

- to identify the state of the art in internal auditing and to create a basis for establishing benchmarks for assessing the internal audit community in the Government of Canada;
- to identify current trends and particular internal audit practices that certain organizations are using successfully and which the audit community of the Government of Canada might find valuable; and
- to make senior government management more aware of internal auditing and the important role that internal auditors should be playing in their organizations.

We felt that this study was especially important because of the changing control environment associated with the federal government's management reform program — Public Service 2000 — which it launched in 1988.

## **SCOPE AND METHODOLOGY OF THE STUDY**

Our study included interviewing the Heads of Internal Audit and members of their staffs in 40 organizations. These organizations included various industry groups, publicly traded and private corporations, and government organizations at the federal, provincial and state levels. Although most of the organizations we visited are in Canada, we did visit a number in the United States that were recommended to us as being among the leaders in internal auditing. In addition to conducting the interviews, we obtained, wherever possible, documented information to support what people told us. The information included mandate and policy statements, audit performance data and, in some cases, demonstrations of audit tools that the audit groups were using.

The program evaluation function which exists along with internal audit in some governments was excluded from our study as our focus was on internal audit, the common element in all the organizations surveyed.

In choosing which organizations to visit, we assumed that the people we initially contacted (the Institute of Internal Auditors, respected individuals in the profession and academics) would know which were among the most effective internal audit groups, in terms of current trends, good practices and techniques. Although our sample was not developed “scientifically”, i.e., not randomly or on any hard statistical basis, we think it valid to assume that we have identified some of the best practices being followed by internal audit groups in Canada and the United States.

## **THE CHANGING BUSINESS ENVIRONMENT**

Virtually every Head of Internal Audit whom we interviewed talked about the dramatic changes taking place in their corporations or government programs.

The globalization of markets, the downturn in economic activity, increased competitiveness, concern for the environment, and new technologies are accelerating the rate of change in the way organizations do things and manage themselves. Many are streamlining their operations and processes. They are reducing costs, eliminating activities that add little or no value and striving to deliver higher quality products and services to their customers. Some indicated that they have had to do so in order to exploit the advantages of free trade or, in some cases, just to survive.

While our study methodology was directed toward gathering information on internal auditing, many of the people to whom we spoke commented on the changes taking place in their organizations. It was clear that these changes were causing many internal auditors to re-examine their own approach to doing business. Most Heads of Internal Audit indicated that changes in their organizations had heightened their awareness of the need for internal audit to "add value" — i.e., improve the organization — if it is to survive in today's environment. Some thought that developments in internal audit should parallel the changes taking place in "the business" of their organization. Essentially, they felt that internal audit skills, approaches, methodology and use of technology must keep pace with developments in the way the organization does business. Exhibit I outlines the nature of these changes. It summarizes the points people raised in our interviews. It should also give a flavour of the transformation taking place in the way many organizations are doing things, and help the reader to understand some of the changes occurring in internal auditing.

## EXHIBIT 1

### CHANGING ENVIRONMENT – CORPORATE CULTURE

#### AN AMALGAM OF COMMENTS OBTAINED FROM VARIOUS ORGANIZATIONS VISITED

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Quality and Reliability of Products and Services	Many organizations are focussing more on customers' needs. It involves developing and delivering quality products and services that exceed customer expectations. These changes are necessary because organizations are facing greater competition and more demanding customers.
Organization <ul style="list-style-type: none"><li>• Delayering</li><li>• More authority and responsibility</li><li>• Participative management and team-work</li></ul>	Some organizations have made very substantial reductions to the levels of management (delayering) and have given individuals more responsibility and authority (empowerment). The purposes of these changes are to allow ideas to move up through the organization without filtering by layers of management, to give people who are closer to customers or operations more freedom to act quickly and independently, to give employees more freedom to decide how they do their jobs and to try innovative approaches. These organizations emphasize total team achievement.
Costs <ul style="list-style-type: none"><li>• Downsizing</li><li>• Simplification of processes</li><li>• Elimination of non-value added activities</li></ul>	Many organizations are significantly downsizing and reducing overhead, at least in part by: <ul style="list-style-type: none"><li>• eliminating non-value added activities;</li><li>• re-engineering and simplifying systems and processes;</li><li>• reducing unnecessary work;</li><li>• employing new technologies; and</li><li>• adopting "best practices".</li></ul>
Control	Some organizations recognize that traditional control processes must be redesigned. The responsibility for controls is migrating from the centre to operating levels along with greater authority. Business units are expected to self regulate.

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## **ROLE AND MANDATE OF INTERNAL AUDIT**

All participants in our sample defined internal audit's fundamental role as providing an independent assessment of the system of internal control. A typical mandate statement for this basic role is as follows:

*“Internal Audit shall independently examine and objectively appraise the adequacy and effectiveness of financial and operational controls of the organization for management and the audit committee of the Board.”*

The written mandate of internal auditing in every organization we visited flowed from the accepted definition established and published by the Institute of Internal Auditors (I.I.A.) Most mandate statements contained the following elements:

- the purpose of the internal auditing group;
- the scope of its authority, including provisions guaranteeing access to people, documents, assets and operations of the organizations; and
- internal audit's responsibility for examining and reporting on financial and non-financial matters, including the effectiveness, efficiency and economy of operations.

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**“Internal auditing is an independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization. The objective of internal auditing is to assist members of the organization in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analyses, appraisals, recommendations, counsel and information concerning the activities reviewed.”**

### ***I.I.A. Definition of Internal Auditing***

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Although most organizations described the role of internal audit in similar terms, the type of audit work they were doing varied considerably. It ranged from financial auditing only to auditing the full range of business activities -- including operations and management issues. See the Relationship Between Internal Control and Internal Audit, pages 12 to 15 of this report.



## **The Evolving Role of Internal Audit — Some Typical Mandates**

Several mandates recognize current trends in business practice and corporate culture. They require internal audit to do certain things (assess risk, satisfy “customers” needs and to “add value”) in fulfilling their primary role. The sections which follow in italics are extracts from various mandates.

Many of the Heads of Internal Audit told us that they are increasingly focussing their audits on the management of risk. Some organizations have risk responsibilities formally recognized in their mandates.

*Assess control and related risks in the organization and to report on how well control and risk are being managed across the organization.*

*Assure all risks are being properly managed by officers charged with the responsibility.*

The mandate of several internal audit groups’ referred directly to serving customers’ needs and to contributing to improved performance. Their focus is on pointing out what can be done better, rather than what is wrong.

*Corporate audits’ mission is to satisfy its [audit] customers’ needs and add value to the business.*

*Provide [audit] customers ... with an independent assessment of the quality of the corporation’s internal controls and business processes, as well as recommendations and suggestions for continuous improvement.*

*Provide dedicated resources in association with business teams to improve business processes continually in terms of quality, reliability, responsiveness and cost.*

## **Other Roles**

Most organizations described additional roles for their audit organizations beyond the fundamental one of assessing the adequacy of controls. Some of these roles are formalized and included in mandate or policy statements on internal audit. In other organizations they are considered as secondary roles or as by-products of carrying out the fundamental role.

The following is a list, in order of frequency mentioned, of the other roles described to us during the interviews. The mandates, which give rise to particular roles, are shown in italics.

- 1) Provide high-potential employees with broad exposure to business activities, corporate culture, the control environment and risk management practices as a training and developmental experience, leading to managerial positions in other parts of the organization.

*Develop leaders by providing a diversified group of high potential individuals with broad exposure and training in challenging business environments.*

- 2) Share expertise and knowledge of risk management, controls and best practices with managers and employees in order to help improve effectiveness throughout the organization.

*Sharing expertise, knowledge and ideas across operating units to enhance effectiveness throughout the corporation;*

*Provide an independent consulting resource on the control aspects of systems, policies and procedures.*

- 3) Identify opportunities for improving economy, efficiency and effectiveness.

*Appraise the effectiveness of the performance of operations in carrying out assigned responsibilities and recommend operating improvements.*

- 4) Provide advice on risk and controls at the design phase of systems and program development.

- 5) Carry out special assignments ranging from consulting-type work, to investigating suspected fraud or wrongdoing.

- 6) Provide assistance to the external auditor.

- 7) Provide reasonable assurance that disbursements to suppliers on cost-reimbursable contracts are in accordance with the terms and conditions of the contract.

There is a strong relationship between the role of internal auditing and the benefits obtained from it. The critical issue is not the type of audit work being performed, but rather that the work must be completely consistent with the objectives and role as determined by top management and the audit committee.

## **THE RELATIONSHIP BETWEEN INTERNAL CONTROL AND INTERNAL AUDIT**

The Heads of Internal Audit whom we interviewed described their role as providing an independent appraisal of the adequacy and effectiveness of the system of internal control. The difficulty in associating the term “internal control” with the role of internal auditing is that there is no single, consistent definition or view of the scope of internal control among organizations. A few of the organizations we visited tended to focus on traditional financial controls, which are primarily designed to protect assets, ensure the reliability of financial records and deter fraud. However, the vast majority of the organizations defined internal control in a much broader way that encompasses virtually everything an organization does to ensure that it will achieve its objectives.

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**“the organization, operating plans, policies, values, procedures and practices put in place to effect the disciplined and efficient conduct of the business and to provide reasonable assurance that business goals and objectives are met.”**

***A Major Corporation's Definition of Internal control***

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Because of the strong interrelationship between internal audit and control, one must understand the scope and nature of internal control to fully appreciate the role of internal auditing.

### **The Elements of Internal Control**

Internal control typically refers to much more than the specific checks and balances that have been commonly associated with internal control in the past. Some organizations feel that control includes the following principal elements:

- organization structure
- standards of business and ethical conduct
- values
- trained people
- policies, procedures, authorizations
- financial and operating information
- physical security
- planning and budgeting
- EDP security

- internal checks and balances
- contingency planning

More specifically, controls are designed to provide reasonable assurance that:

- Business or program goals are met.
- Economy and efficiency are achieved in the use of resources.
- Financial and operating information is reliable and useful.
- Assets are accounted for and protected from losses of all kinds.
- Policies, procedures, laws and regulations are complied with.

Heads of Internal Audit noted the importance that their executive places on internal control. In a number of cases, they showed us documents that their Chief Executive Officers had distributed throughout their organization and which emphasized the importance of internal control. Specifically, these documents defined control, listed its principal elements, and provided guidelines on control, ethical values and business conduct. The following comments on internal control are based on these documents and our interviews.

One organization stated that “internal control not only enables us to meet our responsibilities for protection of assets and the integrity of financial information but is also a key factor in achieving our business goals.” It also said that “the application of attention and energy in maintaining an appropriate control environment is key to our continuing success.” Another stated that “the quality and effectiveness of our internal control systems and the maintenance of high standards of business conduct are essential parts of the successful accomplishment of the mission.” Still another organization pointed out that good internal controls contribute directly to the bottom line. The organizations also emphasized the importance of having only cost-effective controls.

### **Broad Principles for Internal Control**

Among the fundamental control guidelines are the following:

- Internal control systems of high quality should be maintained, consistent with reasonable cost.
- Establishing and maintaining adequate controls at each location are prime responsibilities of management. In other

words, managers must make sure that the controls over the operations and resources entrusted to them are adequate.

- The design and extent of control measures and procedures must match the risk and exposure in the particular circumstances. Before implementing a control, management should be satisfied that the benefits outweigh the cost of operating it.
- Managers should continuously determine whether controls exist and measure their effectiveness.

### **Reconciling Controls and Changes in Management Culture**

Several organizations that have made significant changes in the approach to management by decentralizing, delaying and empowering field employees — i.e., giving them more responsibility and authority — discussed how these changes affect control. They emphasized that **the changes have not lessened the need for the organization to be “in control”**. **The migration of responsibilities through decentralization and empowerment merely changes the nature of the controls and where they should be implemented.** Some organizations pointed out that internal control has become more important than ever before for two reasons: Changes are occurring more quickly, and the levels of review to which operations have been subject, have been reduced. Another organization told us that “Attention to these matters (control environment) is increasingly important. We face a market place characterized by fiercer competition and lower margins. We need to respond rapidly and decisively to new challenges and opportunities.”

The changes in management culture have resulted in a fundamental need to redesign — not discard — the control system. As responsibility for control migrates to the field along with greater authority for decision making, central control decreases. But business units are expected to self-regulate and stay “in control”. Maintaining control in the face of decentralization requires an organization that is well trained, with people who share a commitment to ethical values and business excellence. If these conditions exist, controls can be designed to allow central intervention only when problems are not resolved or they threaten the health of the organization.

Some organizations are doing the following things to make certain that they remain in control:

- issuing guidelines for conducting business and developing control standards that set out the organization's values and principles;
- educating and training managers in risk management and control techniques;
- encouraging the establishment of self-assessment programs through which managers routinely measure the existence and adequacy of controls; and
- developing information that gives early visibility to unfavourable trends and triggers corrective actions.

## **THE EVOLVING PRACTICE OF INTERNAL AUDITING**

During our interviews, we discovered a number of internal audit groups that were dealing in a very dynamic way with the changes taking place in their companies or government departments. Many of these groups were continuously redesigning their approach and practices to stay in tune with a changing organizational culture and new technology and business practices. Virtually all of the groups spoke of the need for audit to add value to (improve) the company or department. Most were moving toward a more participative, collaborative relationship with management and other employees. Many had taken steps to monitor their own performance and to improve their own productivity.

### **The Need to Change the Audit Approach**

Some internal auditors have begun to realize that their traditional audit approaches are at odds with the changes taking place in their organizations. In the past, internal auditors sometimes virtually isolated themselves from managers and other staff in the name of maintaining their independence. Some tended to concentrate on reviewing formal control mechanisms without understanding or recognizing certain compensating or informal controls or the concept of risk management. They sometimes made recommendations that added to the formal control process without adequately understanding the risks involved, or the cost and other effects of implementing the recommendations. The tendency in reporting was to note errors or deficiencies, blame someone or something for the problem, and to forward a report to senior management. This approach tended to strain the relationship between management and the internal auditor. Occasionally, it created confrontation. In this environment, the full potential for internal auditing was seldom realized.

### **Redefining The Audit Approach**

Many of the internal auditors to whom we spoke during the study had recognized that the traditional approach could become dysfunctional, given the changing cultures of their organizations. They saw that they would have to change their mindset and fundamentally redesign their approach if they were to continue to make a difference. Some internal audit groups have responded positively and creatively to change by:

- looking at the auditee as a “customer”;

- using internal audit as a training ground for staff with high management potential;
- adopting a more pro-active approach;
- focussing more on risk management;
- instituting programs to continuously improve the quality of their audits; and
- increasing their use of technology.

Although the shift in mindset and audit approach has taken a wide variety of organization-specific forms, we noted that the pattern of change is widespread. The following briefly outlines the nature of some of the changes:

### *Viewing the Auditee as a “Customer”*

Perhaps the most important change taking place is that many internal audit groups now recognize the auditee — along with the audit committee, top management and the external auditor — as a customer. A major focus is on helping business units to manage risk by identifying problems and suggesting improvements that add value to or strengthen the organization. Several internal audit groups see themselves relating to those they audit as business partners. They believe that they can establish this kind of relationship without compromising the internal auditors’ professional standards of independence and objectivity. Below, we list some of the changes in practice resulting from this change in outlook.

- Some audit groups maintain ongoing contacts and networks within the organization to gather information so that the audit staffs can keep current with any changes in the organization’s culture, business priorities, risks and management concerns. They use this information as a basis for planning audit coverage and to help ensure that audits meet or exceed the customer’s principal audit needs.
- We found that certain audit groups communicate closely with the auditee during the audit. Briefly, communication involves these elements:
  - clearly communicating the audit objectives, scope, approach, reporting strategy to those being audited before the audit starts;
  - involving management in the planning process and at strategic points in the audit process (recognizing that management knows the business better than the auditors) and getting management’s input on



- critical business processes, major risks, trends, concerns and mitigating controls;
  - discussing issues with management as they are identified;
  - working with managers to find acceptable solutions that add value to the organization;
  - reporting detailed findings to the auditee and providing only a summary of truly significant matters to top management and the audit committee; and
  - asking auditees, after the audit has ended, if they were satisfied with the audit, how useful it was, and whether they have any suggestions for improving future audits.
- To improve “customer” service, some groups have established level-of-service targets and monitor their performance against them. The targets include such aspects as the length of time to issue reports after the field work has been completed and the duration of audit from start to finish. We cover these matters in more detail in two other sections of this report: Communicating the Results of the Audit and Measuring Internal Audit’s Performance (pages 37 to 46).

## **Using Internal Audit as a Training Ground**

For some time, most progressive organizations have been using internal audit as a training ground for people with management potential. In fact we found even more evidence of this practice than we had expected. Internal audit is an ideal training ground because it enables staff to get a “birds-eye view” of all aspects of an organization’s activities. It allows them to get to know an organization’s control environment by its business-conduct guidelines, its control standards and its code of ethics. Working in internal audit also provides an opportunity to see a variety of management styles in action. Finally, well run audit organizations involve staff in creative problem-solving projects that produce tangible results. One senior executive we met, in referring to the use of internal audit as a training ground, stated “Where else can you get to see the entire operation of an organization from ten thousand feet?”

Different organizations staff internal audit groups according to different models. But the trend is to staff them with high-potential employees from either inside or outside the organization. We found few career auditors in organizations that emphasize internal audit as a training ground.

Several organizations pointed out the significant number of senior executives in their organizations who had spent time in internal auditing. See Staffing, Training and Development (pages 25 to 27) for more details on staffing the internal audit function.

### **Adopting a More Pro-active Approach**

Some internal audit organizations have broadened their horizons by taking a more pro-active approach. They believe this path allows them to contribute more to improving the quality, reliability, responsiveness and cost effectiveness of business processes. The following are some of the trends we noted:

- During the audit, internal auditors are sharing their knowledge of controls, risk management and best practices with managers.
- More audit resources are being focussed on examining systems and programs at the design stage to make certain that they will provide adequate control in relation to the risks faced. The basic philosophy is that it is better to identify risks at an early stage than to report problems after they have damaged the health of the organization.
- Risk management and audit tools are being left with managers after an audit to help them in self-monitoring risks and controls. In two organizations that we visited, the internal audit function was leading and co-ordinating self-assessment programs throughout the organization. Several other audit organizations are providing expert advice on control as input to self-assessment programs.
- High-technology tools are being developed that allow audit groups to continuously monitor data bases to identify developing negative trends and risks.

### **Focussing More on Risk Management**

A number of audit groups are focussing on risk exposure throughout the audit process. Risk is defined as the probability that an event or action — such as exposure to financial loss, non-ethical conduct, loss of reputation, and non-compliance with legal requirements and business guidelines — may adversely affect the organization.

The degree of sophistication in carrying out risk assessment varies considerably among different audit groups. It ranges from audit

teams assigning a rating to various risk factors on the basis of their knowledge of the business to an automated risk-assessment system based on hard data.

Risk assessment is valuable for a number of reasons:

- In the development of the audit plan, it allows audit groups to focus scarce audit resources on areas where they are likely to add the most value to the organization. Details of various approaches and risk factors used to determine audit coverage are provided in Audit Planning and Risk Assessment (pages 28 to 32).
- Continuously analysing risk through monitoring data bases provides an early warning signal that the auditor can use to change audit priorities and respond to deteriorating situations before serious harm occurs. The section on Responding to the Challenges of Computer Technology (pages 33 to 36) describes this type of analysis in more depth.
- Risk assessment gives the internal auditor a basis for identifying unnecessary control procedure by comparing the cost of controls to potential losses.
- By considering risk, auditors can understand the magnitude and type of risks the organization faces and the people who may be affected. This knowledge is critical for auditors so that they recognize the proper balance between the risks faced and the possible negative effects (including costs) of actions to mitigate those risks.
- Reporting on the magnitude of a risk can be an effective way to alert senior management to the significance of an issue. See Communicating the Results of the Audit (pages 37 to 42) for a more detailed explanation.
- The auditors' expertise in identifying risk can be transferred to business managers during audits. This transfer of knowledge helps managers to identify, analyse and minimize risks in their own areas.

### **Continuously Improving Audit Quality**

Some audit groups have recognized that they need to continuously improve their audit practices if they are to stay relevant in a rapidly changing business environment and continue to meet the organization's audit needs. Although different organizations have

pursued various improvement initiatives, we found some similarities in their approaches:

- Some audit groups benchmark with audit functions from other organizations. Benchmarking involves comparing key audit practices and methodologies to identify best practices from among the participating organizations. The best performers in a given area provide detailed information on how they have achieved high-quality audit results. Other organizations participating in the benchmarking exercise then bring their practices in a given area up to the level of the lead audit group.
- Many auditing groups have developed practices and indicators for measuring and monitoring their audit processes. They believe that measuring their own performance is essential to both achieving continuous improvements in customer service and producing value-added audits. One Head of Internal Audit emphasized this when he pointed out “What gets measured gets better.” The methods used to measure audit performance are discussed in *Measuring Internal Audit’s Performance* (pages 43 to 46).

### **Increasing the Use of Technology**

The increasing use of computers and computer-based information systems at virtually all levels in many organizations has increased the complexity of internal audit work. However, the increasing power and speed of computers and advances in audit software have actually improved the internal auditor’s ability to carry out more effective audits. We found, for example, that some internal auditors are using computers to analyse data in order to monitor risks, identify trends and unusual transactions, and highlight deviations from what internal audit considers normal for the organization.

Many internal audit groups are using computer technology to raise productivity within their own offices. For example, they are using it to update multi-year audit plans and to track any changes in the risk associated with particular auditable activities; to give auditors an on-line system to access audit manuals, to report outlines, audit programs, audit reports and other instructions or guidance; to prepare working papers and to communicate between internal audit headquarters and field auditors.

Details on the use of technology are provided in the section of the report, *Responding to the Challenges of Computer Technology* (pages 33 to 36).

## PART II

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### **AN ESSENTIAL ELEMENT — MANAGEMENT SUPPORT**

Every organization that we visited stated, very clearly and very strongly, that the support of top management is essential if internal audit is to be an effective, contributing part of the organization. It is clear that internal audit is whatever senior management wants it to be.

To a great extent, the relationship between internal audit and top management determines the respect it receives from operating managers. Internal audit grows in stature when its independence and authority are set out in organizational policies. In essence, *senior management must visibly support internal audit if an effective internal audit function is to exist.* They also agreed that a technically sound, ethical, professional internal audit group cannot by itself ensure that the organization will have a superior internal audit function. The support of top-level management is of critical importance.

Management can show its support in many ways. In most organizations, top senior management has issued policy statements that define the authority of internal audit and indicate the support which top management provides to it.

The box shows excerpts from the policies of two companies. In most cases the companies surveyed also issue booklets to each employee that contain the policies with respect to internal audit and provide guidance on the organization's code of ethics and business conduct.

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**“To accomplish their objectives, internal auditors are authorized to have unrestricted access to all relevant company functions, policies, practices, procedures, records, property and personnel....”**

**“In fulfilling its role, Internal Auditing has the full support of Corporate Management and the Audit Committee of the Board of Directors. It has unrestricted access to all records, information and personnel necessary to perform audits, and all employees are expected to cooperate fully with our professional audit staff in this regard.”**

***Internal Audit Policies From Two Corporations***

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## Concrete Evidence of Management Support

More significant than the written policies are the actions of senior management. When management “Walks the Talk” -- backs up its words with concrete action -- it clearly signals its support and the value and importance that it places on internal audit.

In many instances, the support to internal audit appears as a public statement. A recent speech by the head of a major organization (see box) lent support to internal audit and stressed its importance.

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**“...those who really want to get to the bottom of how well an organization, public or private, manages its affairs had best examine what’s happening at the top first. Because its primarily by looking through “the window at the top”...that one can almost detect the first stirring of trouble in an organization.**

**...If that window is cracked in the form of feeble support for internal audit and compliance functions...”**

***Chairman and CEO - A Major Canadian Corporation***

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In virtually every organization that we talked to, the support of top management is strong and continuing. But internal audit must earn that support. Through its observations and recommendations, internal audit must measurably contribute to the organization as a whole by delivering a product that justifies the support and recognition from senior management.

### *Access to Senior Management*

One indicator of support is the extent to which internal audit has free and easy access to senior management and the audit committee. We found that most organizations have this access. We also noted that the amount of access varies from organization to organization. It ranges from one annual meeting with the audit committee, to quarterly or bi-monthly meetings. As well, some organizations provide for internal audit to have access to the audit committee when management is not present. In many organizations, access to top management was immediate if internal audit had identified a significant issue with high potential for losses, and which needed senior management’s immediate attention.

We found a particularly good practice relating to access in one organization that we visited. The Chairman of the Board and the Chief Executive Officer have monthly meetings with the head of

internal audit. These meetings have three main objectives. The first is to signal to the organization the importance top management assigns to internal audit. The second is to enable internal audit to discuss any key issues and concerns it has with top management. The third is to enable top management to discuss its business concerns with internal audit. In this organization, internal audit also attends all audit committee meetings, which are held eight times per year.

Another signal is the time that top management devotes to internal audit. For example, in one major organization the Chief Executive Officer and Chairman of the Board sit in bear pit sessions with the internal audit staff three times per year, generally for periods of one to two days. Other areas of the organization take note of the investment of senior management's scarce time. The demonstration of support is again strongly reinforced.

A further example of a signal of support from management appeared in a provincial government setting. In this particular situation, the province's Management Board was concerned about the quality of work produced by the internal audit community and the level of support that the senior management had been giving to internal audit. To address these concerns, the Management Board created a Steering Committee on Quality Assurance. This committee, consisting of deputy heads of departments and chaired by the deputy head of the government's Management Board, meets twice a year. The creation of this committee sends two messages to government managers. First, having an effective internal audit group is important to senior management, and senior management is prepared to support the function. Second, senior management wants quality in its internal audit community and is prepared to provide the support and direction necessary to achieve this objective.

### *Using Internal Audit as a Training Ground*

As noted earlier, many of the organizations that we surveyed use internal audit as a training ground for their future leaders. These people advance very quickly along their career paths, which sends a strong message to the rest of the organization: Internal audit is valued, and the future leaders of the organization will build on the experiences and skills acquired while they are there. One organization considers this message so important that it tracks, charts and publishes the rate at which managers who have served in internal audit get promoted — a rate which is about twice that of colleagues who have not served in internal audit.

## **STAFFING, TRAINING AND DEVELOPMENT**

### **Recruitment**

Our interviews showed that organizations have distinct methods of recruiting for internal audit. Some companies use internal audit as a “door” to the organization and either recruit directly from universities, colleges and public accounting firms, or hire people with business experience. Others recruit entirely from within the organization. But in all cases, only the brightest and most promising people are recruited. Almost all heads of audit said they prefer their staff to have a wide variety of educational backgrounds.

All of the organizations identified internal audit as a good place for people to gain a broad understanding of how the organization operates. In almost all cases, people were recruited for internal auditing with the understanding or guarantee that they would be placed elsewhere in the company after their tenure. All emphasized that the internal audit group was a place for promising, high-potential people — not an area for “retiring” ineffective or problem employees.

We also found that in many organizations, recruitment into the internal audit group is so selective that the candidate’s application must be supported by a corporate vice-president.

### **Career Auditors vs. the Trainee Approach**

Very few private sector audit groups that we surveyed were staffed by career auditors. The average time spent in internal audit ranged from two to four years for auditors and from three to five years for audit management. But in government organizations, we generally found a significant number of career auditors, although — as in the private sector — in some provincial and state government organizations the trend was toward fewer career auditors.

### **Training Programs**

Four reasons were most often given for why internal audit groups needed and supported training programs:

- to train new employees;
- to improve the performance of existing employees;
- to address job-specific assignments; and
- to enhance career development.



Most small and medium sized internal audit groups viewed training as an extension of the job and not as a separate activity. Most large organizations, however, viewed training as being a separate activity. On-the-job training in a one-on-one situation was the most widely cited method, especially for new recruits to internal audit. Other training methods most often mentioned were:

- internal and external courses and seminars;
- conferences;
- rotating assignments; and
- self-study programs.

Most of the large audit groups had a core training program for their staffs that met the basic needs of auditors from entry level to audit management. We also noted that most organizations saw training as a way to equip staff to do better audits and contribute more to the organization. Accordingly, in these organizations training needs for audit staff are determined strictly according to their performance on the audit and the results of auditee surveys. One organization actually posted the results of these surveys on a bulletin board so that auditors could find out exactly what auditees thought of their work and, more importantly, so that auditors could see where they needed to improve. It is worth noting that communication skills were often listed as needing the most attention.

A number of organizations usually provided training as needed on a particular assignment rather than offering it in a formal program. All of the large internal audit groups had formal training plans, although in the smaller ones, training was often haphazard and usually provided as and when needed rather than as part of the job. The time devoted to training auditors ranged from one day to fifteen days annually, although most organizations in our sample aimed at providing ten days of training per year for staff. Many have provided more in the last two to three years because of the need for internal audit to learn new technology and remain abreast of changes in company culture.

Interestingly, we found that most audit groups were actively engaged in training, but very few of those we interviewed had devoted much attention to evaluating this training, either from the standpoint of job performance or cost benefit.

## **Employee Development**

As mentioned earlier in the section “Role and Mandate of Internal Audit,” senior management sees internal audit as a training ground

for future leaders. With this philosophy in mind, internal audit groups are prepared to sacrifice audit efficiency, if need be, in favour of allowing audit staff to get to know some aspect of the organization's business.

Lending internal audit staff to other areas of the organization is another employee-development practice mentioned in our interviews. In such a program, an auditor is lent to operating groups for periods usually ranging from six to twelve weeks.

*“Lending staff to other areas on a temporary basis has many advantages to Internal Audit, aside from the obvious ones accruing to the line area. Auditors get the chance to show themselves in a different light and to refresh their own perceptions of the realities of working ‘on the line’.”*

## **Mentoring**

Although mentoring is not a new idea, we were surprised at how many organizations mentioned it. They explained that they were bringing it back because it:

- improves employee morale;
- helps new employees to absorb the management culture more quickly and to contribute sooner to the organization; and
- improves audit quality and audit efficiency by providing an informal way to get prompt answers to basic questions.

An organization's approach to mentoring often reflected its culture. We also noted that organizations that emphasized mentoring tended to:

- match the mentor to the individual;
- draw mentors from outside the immediate work group of the individual; and
- change mentors as a person's career progresses.

## **Outlook for Staffing, Training and Development**

Faced with the increasing challenges and changes described in earlier chapters, internal audit groups will be looking for better educational qualifications, especially when recruiting from outside, and they recognize the desirability of professional certification. Finally, they will also be looking at in-house training as a way to provide staff with more of the skills they will need to perform their jobs.

## **AUDIT PLANNING AND RISK ASSESSMENT**

It is a given that the role of internal audit is to serve senior management and to add value to — i.e., improve or strengthen — the organization as a whole. Internal audit assists management in discharging its responsibilities by providing analysis, appraisals and recommendations concerning the activities reviewed. Internal audit also provides management with information on risk exposures and on the adequacy and effectiveness of the organization's systems of internal control.

Risk assessment and analysis are critically important to internal audit for one key reason. It helps audit management to decide where to assign limited audit resources and to define the timing and approach of the audit. Many audit groups that we visited as part of our study are focussing on both identifying the risks faced by the organization and assessing the control framework for minimizing these risks. In these organizations, the work of internal audit is risk-driven.

Risk assessment means considering the following types of questions:

- What can go wrong?
- What is the probability of it going wrong?
- What are the likely consequences if it does go wrong?
- Who will be affected?
- Can the risk be minimized or controlled?
- What is the benefit versus the cost of reducing the risk?

Virtually all the organizations that we visited consider risks when developing their audit plans and allocating audit resources. However, the approach they use varies. For example, some organizations base their approach to risk assessment and planning audit coverage on knowledge of the business and intuitive judgements about the relevant risk factors. Other organizations have developed sophisticated risk-assessment models. They developed the models to assist them in the audit-planning process primarily because the audit universe had become large and complex. In these cases, they needed a structured approach to ensure that all elements of the audit universe would be taken into account. Many organizations have adopted computerized risk models because they wanted to reduce the amount of time spent on initial planning and updating, while ensuring that audit resources are focussed where they will likely yield the most

benefit. These models are essential tools which are used in the audit planning process to identify and evaluate business risks. It is these models that offered examples of the best practices.

### **Risk Assessment and Planning — An Approach**

In the organizations that used risk-assessment models, the approach to the audit-planning process consisted of the following steps:

- identifying the audit population or universe;
- evaluating the risks associated with the auditable units;
- ranking the auditable units according to the risks involved;
- selecting the auditable units to be audited in the year and developing audit plans; and
- reviewing planned audit coverage with management.

#### *Identifying the Audit Universe*

Defining an auditable unit and identifying the audit universe are critical to developing both risk models and the audit plan. For risk models to be used successfully, the defined audit universe must be complete. The auditable units must cover the full range of business activities and may include organizational units, major business units or processes, functions, policies, systems or procedures and information systems.

A number of organizations focus on key business processes when defining their auditable units. A key business process consists of a number of elements or related tasks that may cross organizational lines and which are critical to achieving business objectives. Defining the auditable units in this manner allows the auditor to determine whether all organizational units involved in a particular key business process are operating in a common and co-ordinated way that enables the organization to achieve its business objectives.

Some other groups define business processes in terms of their product or service lines.

#### *Evaluating the Risk Factors in Auditable Units*

Risk factors may be defined as the criteria used to identify the relative significance of, and likelihood that, conditions or events may occur that could adversely affect the organization. In the organizations that participated in our study, the number of criteria they considered ranged from six to thirty-two for each auditable

unit. Differences between industries and the personal preferences of internal audit groups account for the range. The criteria most often considered were:

- date and results of last audit;
- flow of funds;
- complexity of operations;
- sensitivity of operations and the effect of public disclosure;
- control environment;
- confidence in operating management;
- changes in people, systems and the operating environment; and
- size of the operating unit.

### *Ranking the Auditable Units By Degree of Risk*

The auditor looks at all auditable units in terms of criteria such as those noted above and uses judgement to assess the degree of risk associated with each criterion.

The organizations that we visited generally used either a three- or five-point rating scale, as shown in the box.

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#### **Organization X**

- 1 = probably not a problem**
- 2 = possibly a problem**
- 3 = probably a problem**

#### **Organization Y**

- 0 = little or no risk, which if the risk occurred the damage would be negligible;**
- 1 =**
- 2 = medium degree of risk, which if occurred would result in minor financial loss;**
- 3 =**
- 4 = considerable risk which could result in significant damage.**

#### **Organization Z**

- 1 = Low Risk**
- 2 =**
- 3 = Moderate Risk**
- 4 =**
- 5 = High Risk**

#### ***Risk Evaluation Rankings Used by Three Organizations***

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Each risk criterion is also assigned a weighting to reflect its relative importance. Multiplying the risk factor (numeric value assigned to each risk criterion) by the weighting produces a “risk value” for

each risk criterion. The sum of all risk values produces a Risk Evaluation Factor or score.

The Risk Evaluation Factor provides an indicator of the degree of risk associated with each auditable unit and the risk of a unit relative to all other units. Several of the risk models we reviewed also contained reasonability tests to determine whether all staff had evaluated similar auditable units in a similar manner.

An essential element of the risk evaluation and ranking process is the review of the ranked results by audit management. Generally, the results are reviewed to ensure the integrity of the model and the validity of the assumptions upon which the model was based. The review was also to ensure that results of the ranking reasonably reflect management's views of the risks faced by the business.

### **Selecting Auditable Units and Developing Audit Plans**

Although we noted a number of different approaches to developing audit plans, the choice of auditable units was, in general, tied to the Risk Evaluation Factor developed through evaluating and ranking auditable units as explained under the previous heading. One organization used the risk evaluation factor for each auditable unit to determine the audit frequency. This approach is summarized in the following box.

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<b><i>Risk Score Range</i></b>	<b><i>Audit Frequency</i></b>
<b><i>0 to 137.5</i></b>	<b><i>Every four years</i></b>
<b><i>137.76 to 177.51</i></b>	<b><i>Every three years</i></b>
<b><i>177.52 to 217.27</i></b>	<b><i>Every two years</i></b>
<b><i>&gt; 217.27</i></b>	<b><i>Annually</i></b>

***Audit Frequency determined by Risk Score.***

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Several of the computerized models that we saw during our study also generated the audit work schedule and resource requirements.

### **Reviewing Planned Audit Coverage with Management**

In the organizations we visited, internal audit carries out the risk assessment and audit planning process in co-operation with others. In keeping with the service-oriented philosophy which most internal audit groups have adopted, input is solicited from management, members of the audit committee, internal audit staff

and the external auditors. As well, many internal audit groups review the planned audit coverage and the results of the ranking of auditable units with senior management. Some groups told us that this review is the most critical part of the audit planning process and that it provides several benefits:

- Internal audit can demonstrate to senior management how the planned audit coverage addresses the key business risks faced by the organization.
- Internal audit can discuss with senior management any management concerns and the nature and magnitude of the risks associated with areas not included in the planned audit coverage.
- Internal audit can discuss the adequacy of its resources in relation to the planned audit frequency.

Without question, it costs money to develop and maintain risk-assessment models, some of which monitor and rank the risks associated with thousands of auditable units. However, those organizations that had developed the models agreed that the benefits did outweigh the costs.

### **Risk Assessment – Individual Audit Programs**

Some of the organizations that participated in our study and used risk analysis as an audit planning tool, used it for more than merely selecting the auditable units. Within an auditable unit, they use risk assessment to identify critical internal controls and to reduce the nature and extent of audit testing. One of the organizations we visited had used limited-scope reviews to examine auditable units in the lowest-risk categories. In these assignments, an experienced auditor reviews the key systems and controls with the objective of limiting the scope of the work to examining the most critical controls. If problems are noted in performing the work, the assignment reverts to a full audit.

### **Risk Assessment – An Ongoing Process**

In some of the organizations we visited, risk assessment is much more than just one part of the annual audit-planning process. Risk analysis and monitoring have become continuous, ongoing processes which identify problem areas and serve as a basis for making “smarter” decisions about where to allocate audit resources.

See page 34 and 35 for a brief discussion of how one organization that we interviewed has used technology to enable it to assess risks on a continuous basis.

## **RESPONDING TO THE CHALLENGES OF COMPUTER TECHNOLOGY**

The rapid changes caused by the continuous introduction of new computer technology have made the internal auditor's job more complex. Most organizations interviewed agreed that technology will have an increasingly greater effect on internal audit. Internal auditors are changing their audit approaches and using technology more and more to improve both their productivity, and the quality of their audits.

The challenges posed by technology can be briefly summarized as follows:

- Management is increasingly relying on automated expert systems to make decisions that people (subject to the traditional systems of checks and balances) used to make.
- Auditors must audit in the midst of new and increasingly complex technological systems. In organizations that have a mixture of old, new and mature systems, the complexities are even more pronounced.
- Internal auditors must adapt to fundamentally redesigned systems of internal controls, with controls changing from the traditional checks and balances to largely self-regulating systems. This changing control philosophy requires auditors to shift from doing after-the-fact audits to getting involved from the start in the design and implementation of the system to ensure that adequate controls and risk-management processes are built into the system.
- Internal audit must exploit new technology and the opportunities it presents for improving the quality and productivity of audits.

This section of our report will describe some of the ways in which internal audit groups are responding to these challenges through:

- getting involved early in systems and program development;
- continuously monitoring and analysing data;
- developing EDP audit skills in all internal audit staff; and
- developing technological tools to increase their productivity and the quality of their work.



## Early Audit of Systems and Program Development

We found that some internal audit groups are taking a pro-active audit approach to business systems development. A pro-active approach requires internal audit groups to audit the development and implementation stage of new systems and programs.

Pro-active audit groups view their audit involvement in the design, testing and implementation phases of new systems as crucial.

Early involvement allows them to provide positive assurance that the business systems have been designed, tested and implemented with adequate controls and proper standards of risk management. Auditing both the risks within the new business processes, and the design of proper controls to minimize and manage the risks is one of the primary roles of many internal audit groups. The box shows an example of such a mandate.

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**To provide assurances that the organization's worldwide:**

- **information assets are properly secured and controlled;**
- **Risks are managed effectively;**
- **Processing Centre's operations are conducted effectively in accordance with management's goals, policies and procedures and in compliance with good business practices.**

**To sign-off that the organization's delivery system are designed, tested and implemented with adequate controls and according to standards for proper risk management.**

***Illustrative Information Technology Audit Mandate***

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## Continuous Monitoring of Data

In many organizations today, top management, as part of its efforts to downsize, is relying far more than it has in the past on automated expert systems to make decisions. Such decisions may, for example, relate to reordering inventories, approving credit requests, and transferring funds. In parallel with the advances in technology, the number and complexity of transactions have increased.

To meet the audit challenges created by this environment, some internal audit groups have turned to technology. Some have developed software that allows them to continuously monitor the organization's data. One such organization, with many geographically dispersed business sites, has developed an automated risk-assessment system. This system is designed to compute a risk score and a performance indicator score for each business unit. The scoring allows internal audit to monitor business units on a monthly basis and to know whether the risks associated with any given business unit have changed. The system

also compares actual operating results with predetermined targets and notes unfavourable variances. For example, the system can tell if a business unit which was previously a low-risk unit has become a high-risk unit due to such things as a decrease in composite profit margins or an unfavourable change in inventory levels. The system acts as an early warning tool that can identify a problem in a business unit before it develops into a serious problem for the organization. The information the system provides allows the audit group to revise its priorities and carry out audits before a weakness has a significant effect.

In an effort to become pro-active in its audit approach, one organization that we talked to has developed another software package that monitors and tracks changes in business trends within the organization over time, rather than against predetermined targets as in the system noted above. In so doing, the package allows internal audit to monitor the changing risks of the organization and analyse emerging business trends. For example, the software can track how the aging of the organization's accounts receivable has changed over time. It can also predict how the aging will change in future if present trends continue. This predictive capability allows internal audit to detect potential problems before they affect the health of the organization and, if necessary, to revise its planned audit coverage.

### **Developing Technological Tools to Increase Productivity and Audit Quality**

Virtually all the organizations that we visited use microcomputers in their audits. Typically, internal audit staff have spreadsheet and word processing software packages. However, many organizations use the technology for little more than preparing working papers and word processing audit reports, although some have advanced much farther. We noted in our study a number of innovations which improved internal audit's efficiency and effectiveness. These innovations include such things as:

**Continuous Monitoring of Data.** As described earlier in this section, internal audit groups have developed software for monitoring data on a real-time basis. This tool improves both the efficiency and effectiveness of internal audit. The task of constantly monitoring all transactions on a real-time basis can be carried out only with the help of computers.

**Interfaces With Corporate Data Bases.** One organization we visited is using a team of experienced internal auditors to develop a mainframe-based online computer system for use in conducting

audits. The expert system will ultimately link Corporate operating and financial data to key performance indicators through a series of user-friendly menu-driven screens. Auditors located across the country will use system output to efficiently and effectively evaluate customer service, controls and identify bottomline improvements for implementation by management. The embedded expertise ensures audit findings of consistent quality and eliminates the wasted effort of re-inventing the wheel each time one of these audits is conducted.

The organizations inventory of over one hundred audits will be updated as audits are completed. The results will be tracked and related trends and variances used to establish future audit priorities.

The first module which summarized revenues by type has, at the outset, reduced audit time by twenty-five percent for this type of audit.

**On-line Communication.** We found several internal audit groups that use computerized systems to improve their efficiency. This technology allows internal audit management to follow the progress of audits on a real-time basis, and to make more timely adjustments to audit approaches or focus. For example, audit management in one of the organizations that we surveyed can review and approve working papers and reports without having to go into the field or wait for the auditors to return to the Office. "Instant" communication cuts the time needed to issue audit reports and, therefore, adds to the efficiency of the audit itself.

This organization also has well-developed library-type data bases from which field auditors can directly access audit programs, manuals, forms and previous audit reports.

### **Developing EDP Audit Skills**

Every organization that we visited had recognized and was trying to deal with the effect of rapidly changing computer technology and the ever-increasing number of ways it was being used. We noted that most internal audit groups are working toward integrating the work of financial and EDP auditors. To achieve this objective, internal audit groups are providing their staff with additional training in EDP audit skills. In parallel with the development of these skills in all internal audit staff, the computer audit groups are becoming even more highly specialized and technical. These groups tend to focus on data processing centres and the systems development process.

## **COMMUNICATING THE RESULTS OF THE AUDIT**

### **A More Constructive Reporting Strategy**

Earlier in this report, we noted the migration of control responsibilities to operating levels and the expectation that business units would self-regulate. Faced with these and other changes, many internal audit groups have brought their audit-reporting practices into line with new organization realities. For example, as noted earlier, many audit groups have adopted a more co-operative approach to auditing that focusses on ways to improve things, not on fixing the blame. This approach is reflected in their reporting; internal auditors in a number of organizations see their reports as guides for future improvement. The reporting strategy concentrates on getting the auditee to react positively to the findings and to make improvements. It recognizes that effective reporting means getting continuous feedback from the people who receive the reports and monitoring their response to the observations and recommendations.

Here are some of the things that internal audit groups are doing to improve their reporting strategies:

- Internal audit advises managers of deficiencies as they are identified. Managers and auditors can then work together to identify acceptable solutions before the report is issued.
- Audit reports, containing details of audit findings go only to those who have responsibility for the controls, systems or operations in question and who are in a position to make improvements.
- Only summaries of audit findings, themes, or overall audit opinions or ratings are reported to senior management and to the Audit Committee. Most internal audit groups also report promptly to senior management any exposure that could harm the health of the organization, or instances in which they have found problems in an audit that have not been fixed within a reasonable time.
- Audit reports are issued as soon as the audit is finished.
- The audit reports rate the overall adequacy of controls for each audit.

## **The Audit Report**

Through the audit report, the auditor documents the audit scope and issues and makes recommendations. Accuracy in an audit report is, of course, essential. But many other factors are important to successful reporting. These range from the appropriate tone, the readability and the design of the report to consideration of the effect that implementing the recommendations will have on the operations of the organization. All the auditors interviewed recognized the need to effectively communicate the results of the audits.

Generally, an internal audit report's major purpose is to encourage constructive, cost-beneficial change by convincing management that the observations are correct and worthwhile and warrant their attention.

While the format and distribution of reports differ among organizations, some elements are common to most internal audit reporting. These include:

- a statement of the scope and objective of the work, including limitations;
- an identification and analysis of the issues;
- the determination of the root cause of any problem or deficiency;
- an outline of the exposure or effect of the problem;
- the response from management, including a timetable of planned corrective actions; and
- an overall rating on the adequacy of controls.

## **Rating the Adequacy of Controls**

Most of the groups surveyed form conclusions based on their audit work. They generally use a three-point rating system to indicate the adequacy of controls, with some using a four- and five-point rating system. Even those groups who said they did not use such a system presented their conclusions on the adequacy of controls in other ways in the report.

The rating system is a mechanism for reporting rather than for evaluating performance. Its main purpose is to summarize the audit findings for top management, the audit committee and the Board of Directors. Basically, it gives the reader a quick signal or indicator of the risk or exposure faced by the organization.

An example of a five-point rating system used to grade controls is as follows:

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**Satisfactory**

1. **Good, no control exposures.**
2. **Minor control exposures.**
3. **Currently operating at an acceptable level of control; exposures noted and if not corrected could result in an unacceptable condition.**

**Unsatisfactory**

4. **Unacceptable control exposures posing a significant risk to the organization or process in place; enough deficiencies found to prove system not working properly.**
  5. **Serious deficiencies with significant consequences found; basic controls to ensure integrity of data and protection of assets lacking.**
- 

The methods used to establish the grades varied greatly from organization to organization and involved using a great deal of judgement, especially when a decision had to be taken between assigning a 3 or a 4 rating. A few of the organizations used checklists and decision trees to help them decide.

## **Responses to the Report**

In most cases, management comments are also included in each report. If someone fixes a problem before the audit is finished, either this fact is noted in the report or the audit issue is dropped. In some cases, management may prepare a plan of action to correct reported deficiencies and to implement the recommendations. Internal audit would include the plan in the final report. Usually the auditee must respond within 30 days after the final report has been issued. In one organization that we surveyed, the auditee's response takes the following form:

- accepts the report and describes the plan to act on the recommendations;
- accepts the report, but plans to implement a solution other than the one presented by internal audit - must describe the solution.
- rejects the report - must give reasons for the rejection.

## **Dispute Settlement**

Virtually all the Heads of Internal Audit told us that the vast majority of auditees accept the audit findings and try to resolve any problems identified. Most organizations have established a mechanism to settle disputes that may arise when an auditee rejects the findings or recommendations. Some organizations have set up a management audit committee or an arbitration panel that rules on disputes. When the potential effect of an issue is of such significance that if left unresolved it could seriously harm the health or image of the organization, both senior management and the audit committee of the board become involved.

## **Distribution of Reports**

Many audit groups identify the auditees as the most important recipients of their audit reports. In other words, the people who may benefit most from the audit and who are in a position to correct any problems or weaknesses are the primary “target” readers. They receive the detailed reports, with only summary reports going to higher levels of management (the higher the level, the more condensed the summary). Detailed reports are, of course, available if requested. Most of those we interviewed distribute the reports in this way. However, we found that a significant number of organizations were providing the detailed reports to upper level management and the audit committee. In these instances, senior management and audit committees wanted the detailed reports, preferring to do their own synthesis and determine for themselves what was and was not important.

Most audit groups also send audit reports to people responsible for various functions. For example, one audit group sent a report that identified a computer-system problem to the Vice President, Systems Development. Copies of reports are also made available to the external auditor. Some internal audit groups analyse the issues to identify those that may be of interest or relevance to other parts of the organization. They ensure that good practices and audit recommendations are distributed to appropriate persons in the organization in order to get maximum benefit from the audit.

## **Style, Format and Timeliness of Reports**

We found almost as many report styles as there were audit groups. Each internal audit group works with management to determine

the style, format and degree of detail that will satisfy particular needs.

We found that most internal audit groups try to make their reports more inviting to their readers through creative design and typesetting and by including graphs, tables, charts and pictures. They have found that readers can extract information from these reports more efficiently and effectively. Many groups also send their people on writing courses and, in some cases, hire writers and editors to make their reports more readable. Almost all entities use some form of executive summary to highlight their findings and recommendations.

In almost every case, especially in the private sector, we found that Heads of Internal Audit emphasize the need for clarity and the avoidance of unnecessary detail. As well, all are working to issue their reports more promptly. Some issue their final reports immediately after they have finished the field work. Others take up to ten months to get their reports out. Most of the groups, however, issue their final reports within two weeks of finishing the field work.

The average audit report is between five and seven pages long, supplemented with fact sheets or appendices. The size of the report depends, of course, on the size of the audit assignment, the complexity of the entity being audited and the duration of the audit. Most groups that we surveyed try to limit their audits to four weeks in order to produce timely reports of manageable size.

### **Follow-up of Observations and Recommendations**

Although all internal audit groups recognized that they have ultimate responsibility for follow-up, the manner in which it was performed varied considerably from organization to organization.

Our interviews showed that the audit community is equally split on who is responsible for monitoring follow-up. Half said that management was entirely responsible for monitoring and follow-up, while the other half said that internal audit was responsible. (Some of these felt that it was internal audit's responsibility to monitor follow-up on behalf of management.) While some organizations leave follow-up until the next audit, others have an elaborate computerized system to track and clear the implementation of every recommendation.

We were told that if the follow-up determines that an audit issue has not been resolved, this fact would be reported to higher levels in the organization. Many groups indicated that their senior



management and audit committees take a dim view of audit issues that are not satisfactorily resolved.

### **A Method to Capture the Lessons Learned**

As a postscript to this section, we mention an interesting (if not unique) practice of one organization we interviewed. It relates to post-closing interviews, “lessons-learned” meetings and debriefings, which every auditor has experienced. These sessions usually start with a common question:

“If we were to do the audit over again, knowing what we know now, how would we do it differently?”

These meetings usually produce a list of audit tools and things that can be used or done immediately to make current audits more effective, and things that can be done in future when the same assignment is repeated. Knowledge for immediate use is not a problem, but future use of today’s knowledge can be because it often gets lost over time.

We found that one audit group has a different approach for preserving “lessons learned” for future use: It videotapes the audit team’s final debriefing meeting held to capture the lessons learned on the audit and to close out the audit files. The video forms part of the permanent file.

The video approach is particularly useful for these reasons:

- The video supplements the permanent files, which, of necessity, are usually restricted to matters relating directly to the audit and the auditor’s knowledge of the entity.
- In effect, the video becomes the corporate memory, which is particularly important.

## **MEASURING INTERNAL AUDIT'S PERFORMANCE**

In earlier chapters of this study we noted how a changing management philosophy and culture are changing the face of internal auditing. Internal auditors are placing more emphasis on providing service to managers, producing audit products that add value to their organizations, and improving their own productivity. Several Heads of Internal Audit stated emphatically the importance of measuring audit performance in these areas if it is to achieve continuous improvement and be held accountable.

Virtually all internal audit groups that we visited have developed ways to measure their own performance. Most recognize that it is difficult to measure audit performance. Clearly, it is a challenge to measure such things as the value of audit recommendations for improving control systems, the deterrent effect on wrongdoing because of internal audit's presence, and the effect on the organization's well-being of having auditors talk about policies, ethical values, risk management and control throughout the organization. However, the leading audit groups are using innovative approaches to measure their performance. For example, they are obtaining feedback on audit performance from audit customers, setting audit performance targets and measuring and monitoring actual performance over time, conducting benchmarking exercises with other audit groups, monitoring career progression and regularly surveying internal audit staffs. These groups believe that they have enough information to improve their customer service and audit performance.

Some groups use dollar savings or recoveries as a result of their audit work to measure the value of audits. While some people believe this practice provides a measure of internal audit's contribution, some groups do not use (or have discontinued) this practice because of potential disputes with management over who "owns" the savings. It also may put undue emphasis on things that are quantifiable as against contributions that, while they can not be measured in dollar and cents, may be much more valuable.

Most audit groups believe that the costs of measuring performance are more than offset by the resulting improvements in audit productivity and the quality of audit products. Several groups that have extensive performance measures for their audit activities showed us statistics indicating that they have achieved substantial improvements in such matters as audit coverage and the relevance of audits, timeliness of reports and the time taken to carry out audits.

Under the following headings we describe the key methods that the audit groups we talked to are using to measure their performance.

### **Audit–Customer Satisfaction Surveys**

Most audit groups that we visited collect information on audit performance from many sources such as the Audit Committee, senior management, the auditee and the external auditor. They get much of this information through direct person-to-person contact during the audit. Many audit groups, however, have designed a survey questionnaire that they use to get feedback from their audit customers.

The surveys (varying in length from twelve to nineteen questions) are given to the auditee after each audit. They usually request the auditee to assess audit performance by grading each question on a scale of one to five. The survey questions deal with matters such as the quality of the auditor's communication, the auditor's understanding of the business, whether the audit met the auditees' needs and expectations, the quality and usefulness of the report, and whether the audit was worthwhile to the organization.

The audit groups analyse the responses, combine the results, chart the data and monitor the trends and progress in performance over time. When the feedback from the surveys indicates unsatisfactory performance, an audit group will respond by redesigning the audit processes and providing training to correct any weaknesses or deficiencies. Some groups circulate survey results to their entire staff.

### **Comparing Practices and Performance with Other Organizations**

A number of internal audit groups benchmark audit processes and practices with internal auditors from other organizations. Several groups meet regularly with others to compare their audit methodologies and practices. They identify best practices in a given area and use the information to develop new ways of doing things in their own organization. Each year, one organization targets for benchmarking three or four others that have solid reputations for good internal auditing. Benchmarking is a learning process and is used as a catalyst for improving the quality and productivity of audits. In another case, one company benchmarks with others within the corporate family. In some cases, an audit

group will recognize an area that needs improvement and search out a leader in that field.

Several organizations have developed indicators that allow them to compare themselves with other organizations. These indicators include:

- audit costs as a percentage of assets or liabilities;
- number of auditors as a percentage of total employees;
- average salary per auditor.

### **Measuring the Quality of Audit Processes**

The various audit groups that we interviewed use several different models for measuring audit quality and performance. A significant number have identified performance targets for measurable parts of the audit process. These cover such matters as the time for each of the major phases of the audit, the elapsed time of the audit, the number of days between completing the audit work and issuing the report, the number of recommendations implemented in relation to recommendations made, and audit project hours to total available hours. Actual performance is compared with targets, and trends are monitored over time.

Others have adopted more elaborate methods to measure and monitor audit performance. The process basically involves a series of steps:

- defining the major elements of the audit processes used to produce the audit reports;
- identifying those steps in the audit process that are critical to the success of the audit and developing a list of what could go wrong at each step;
- developing a questionnaire that can be used to measure how well each step was completed;
- completing a questionnaire for each audit;
- capturing and summarizing the data on audit performance and prominently displaying the data to staff; and
- monitoring data on audit performance over time.

A number of internal audit groups told us that this approach has enabled them to improve their audits and provide better service to both auditees and management.

## **Monitoring the Career Progression of Internal Audit Graduates**

As noted earlier, internal audit is being used more and more as a training ground for high-potential people. During our interviews, we were often told that an important indicator of internal audit's performance is the number of graduates from internal audit who are placed in senior management positions.

In one organization, where the development of management leaders was part of the mandate, the placement and career paths of internal audit "graduates" are carefully tracked and monitored.

## **Measuring Employee Satisfaction**

Most Heads of Internal Audit to whom we spoke recognized that people are their most important resource. One of the key human-resource objectives of the audit function is to develop motivated, loyal, trusted employees who are capable of working in team situations. To meet this objective, some internal audit groups regularly use techniques such as employee surveys, the appraisal process and round tables to collect information on their employees' satisfaction, well being and morale. This information is useful for detecting employee concerns about the quality of the work environment; rewards and recognition; employee involvement in decision making, job content, adequacy of training, quality and ethical values of the group, and communications. All organizations emphasized the importance of acting promptly to address concerns in these areas. Some groups capture the data, display it to their staff and monitor improvements.

## **FUTURE DIRECTIONS FOR INTERNAL AUDITING**

In our interviews with the Heads of Internal Audit, we asked what future directions they saw for internal auditing. The answers, of course, reflected the state of internal auditing and the management culture of particular organizations. Some groups' views of the future may in fact be the present reality in other groups. Most groups, including those that appear to have been leaders in developing or adopting best practices, believe that all audit processes must be constantly reviewed to remain relevant in a rapidly changing business or government environment. The process of continuous improvement never ends.

The following is a list of points or prescriptions for the future that tended to be consistently mentioned in our interviews.

1. The shift is toward more pro-active, preventive auditing rather than after-the-fact detective auditing. The idea is to identify risks, trends or breakdowns before a big problem occurs. Strategies for achieving this goal include:
  - **Greater use of technology in carrying out audits.** Of particular interest is the use of technology to constantly monitor risk and operational indicators. Using technology in this way improves audit reaction times where risks are increasing or operational problems are occurring.
  - **Earlier audit involvement at the design and implementation stages of systems and programs.** Such involvement is essential, because a changing management culture requires that real-time control mechanisms be built in the processes themselves.
  - **Even greater attention to trend and risk analysis in planning, carrying out the audit and reporting.**
2. The trend is toward a higher level of skills and more expertise in the audit organizations. Some organizations felt that better technology and more focussed audits will require greater expertise within the audit group, but fewer auditors.
3. Some Heads of Internal Audit believe that developing more self-assessment programs, which require management to identify risks and assess basic controls, would allow internal audit to concentrate more on high-level issues and business processes that cut across functional lines.
4. The co-operative, collaborative approach between the auditor and the auditee will continue. Specifically:

- As organizations become flatter and self-regulation prevails, some see a need to continue to refine the dynamics between auditors and managers.
  - Some audit groups felt that auditors would be called upon to play a greater role in using their expertise in controls and risk management by advising and counselling others in the organization on these matters.
5. Many of those we spoke to felt that there is still substantial room for developing a more service-oriented internal audit function.
  6. Some believe that improved processes are needed to reduce the period of audit so as to reduce audit disruption to operations.
  7. Others think that communicating best practices identified in other parts of the organization or through benchmarking exercises will add value.
  8. A few noted that re-engineering the organizations' systems and integrating them with those of suppliers and other business alliances will add new dimensions to the internal auditors role.
  9. A few spoke of the challenges that new technology presents for the audit community and the need for auditors' skills and knowledge to be aligned with the organizations' technology strategy.
  10. Several groups believe that internal auditors need to develop the methodology and the expertise to audit environmental issues.

## **CONCLUSION**

Clearly, public and private sector organizations differ in many respects. However, federal government departments can learn from some of the best practices described in this study report. We feel that internal audit units in the government can and should adapt and adopt many of these practices.

The key thread running through the organizations that we talked to was that internal audit is playing a critical, constructive and often pro-active role in monitoring and reporting on the quality of controls in their organizations, which are changing shape through downsizing, delaying and decentralization. Although control may be shifting from the centre to the field, control remains essential. And internal audit is evolving to retain its key-player status by working more closely with management at all levels to maintain a cost-effective control regime.