TYPES OF AUDIT AND AUDITING STANDARDS

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THE WHY OF AUDITING

The answer to this question can be found in the economic relationships both within an entity, and between the entity and other parties that have a vested interest in the entity.

A historic relationship exists between accounting and auditing in entities.

Until the late 18th and early 19th centuries most organisations were relatively small and were owned and operated as sole proprietorships or partnerships. However, the birth of modern accounting and auditing occurred during the industrial revolution, when corporations needed to raise capital to finance expansion. Corporations issued shares and bonds to the public and borrowed funds from financial institutions. Thus, the growth of the modern corporation led to the presence of absentee owners (shareholders) and the use of professional managers who ran the corporation on a day-to-day basis. In this setting, the managers served as agents for the shareholders.

Stewardship

Stewardship is the name given to the practice by which productive resources owned by one person or group are managed by another person or group of persons. Today most businesses are operated by limited companies which are owned by their shareholders and managed by directors appointed by the shareholders. Similarly, African Central banks are Government owned and are managed by Board of Directors appointed by the Government.

Stewardship Accounting

Owners who appoint managers to look after the owner’s property will be concerned to know what has happened to their property. The process whereby the managers of a business account or report to the owners of the business is called stewardship accounting. This reporting and accounting is usually done by means of financial statements.

Financial Statements

Financial Statements can take many forms. The best known is the profit and loss account and balance sheet of businesses. In the specific case of limited liability companies, financial statements are produced annually and take the form of a Profit and Loss Account (Income Statement), Balance Sheet, Cash Flow Statement, Statement of Changes in Equity and notes to the financial statements.
Parties to financial statements

Historically, annual reports and accounts of companies are produced by the directors (as managers) to the shareholders (as owners), and other people were not expected to be interested in them. However, today a much wider range of people are interested in the annual report and accounts of companies and other organisations.

The following people or groups of people are likely to want to see and use financial statements.

a. Actual or Potential
   i) Owners or shareholders
   ii) Lenders or debenture holders
   iii) Employees
   iv) Customers
   v) Suppliers

b. People who advise the above – accountants; stockbrokers; credit rating agencies; financial journalists; trade unions, statisticians.

c. Competitors and people interested in mergers, amalgamations and takeovers.

d. The government, including the tax authorities, departments concerned with price control, consumer protection, and the control and regulation of business.

e. The public, including those who are interested in consumer protection, environmental protection, and political and other pressure groups.

All these people must be sure that the financial statements can be relied upon.

Why is there a need for an audit?

The problem which has always existed when managers report to owners is – Can the owners believe the report?

The report may:

a. contain errors
b. not disclose fraud
c. be inadvertently misleading
d. be deliberately misleading
e. fail to disclose relevant information.
A further point is that modern companies can be very large with multi-national activities. The preparation of the accounts of such groups is a very complex operation involving the bringing together and summarising of accounts of subsidiaries with differing conventions, legal systems and accounting and control systems. The examination of such accounts by independent experts trained in the assessment of financial information is of benefit to those who control and operate such organisations as well as to owners and outsiders.

Many financial statements must conform to statutory or other requirement. In addition all accounts should conform to the requirements of relevant Accounting Standards. It is essential that an audit should be carried out on financial statements to ensure that they conform to these requirements.

**Overview of the Agency relationship leading to the demand for auditing**

<table>
<thead>
<tr>
<th>Principal</th>
<th>Contract</th>
<th>Agent</th>
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<tbody>
<tr>
<td>Shareholders</td>
<td>Provides a Financial Report</td>
<td>Manager</td>
</tr>
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<td></td>
<td>Verifies the correspondence Of the Financial information in the report to the contract</td>
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<tr>
<td>Issues audit report</td>
<td>Auditor</td>
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**Auditing and Assurance Services**

While the historical demand for auditing services developed from contractual relationships between shareholders and managers, recent changes in the business environment have resulted in requests for auditors to provide services beyond traditional financial statement audits i.e. Assurance Services. Auditing services are a subset of assurance services.
General definition of auditing

Auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users.

A number of phrases in this definition require additional explanation;

- **Systematic process** implies that there should be a well-planned approach for conducting an audit. This plan involves **objectively obtaining and evaluating evidence**.

- The evidence gathered by the auditor must relate to **assertions about economic actions and events**. For example, financial statements prepared by management contain numerous assertions. If the balance sheet contains an amount of GH¢100 million for property, plant, and equipment, management is asserting that the company owns the assets, that it uses them in the production of goods and services, and that this amount represents their undepreciated historical cost.

- The auditor compares the evidence gathered to assertions about economic activity in order to **assess the degree of correspondence between those assertions and established criteria**.

- While numerous sets of criteria are available for measuring the degree of correspondence, generally accepted accounting principles (GAAP) are normally used for preparing financial statements.

- **Communicating the results to interested users** is concerned with the type of report the auditor provides to the intended users.

- The type of communication will vary depending on the type and purpose of the audit.

- In the case of financial statement audits, very specific types of reports communicate the auditor’s findings. These are the statutory audit report by means of which the auditor expresses an opinion on the financial statements and a Management Report/Letter highlighting weaknesses in internal control and making appropriate recommendations for improvement.

- For other types of audits, the content and form of the reports vary with the circumstances.

- Auditing is concerned mainly with the reliability of financial information and the credibility added by the auditor’s independence and competence.

**Assurance services** are independent professional services that improve the quality of information, or its context, for decision-makers.
Extending auditors' activities to assurance services allows the auditor to report not only on the reliability and credibility of information but also on the relevance and timeliness of the information. Some examples of assurance services include the following:

- **Risk assessment** – assurance that the entity’s profile of business risks is comprehensive and evaluation of whether the entity has appropriate systems in place to effectively management those risks.

- **Information system reliability** – assurance that an entity’s internal information systems provide reliable information for operating and financial decisions.

- **Electronic commerce** – assurance that systems and tools used in electronic commerce provide appropriate data integrity, security, privacy, and reliability.

### RELATIONSHIP BETWEEN AUDITING AND ASSURANCE SERVICES

<table>
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<tr>
<th>SERVICE</th>
<th>CHARACTERISTICS OF INFORMATION REPORTED ON</th>
<th>DEFINITION OF SERVICE</th>
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<tbody>
<tr>
<td><strong>AUDITING</strong></td>
<td>Reliability Credibility</td>
<td>A written report on an examination of financial statements for a client.</td>
</tr>
<tr>
<td><strong>ASSURANCE</strong></td>
<td>Reliability Credibility Relevance Timelines</td>
<td>Professional services that improve the quality of information, or its context, for decision-makers.</td>
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While there are many types of audits based on the definition previously provided, generally they are discussed under five types:

- Financial Statements Audit
- Operational Audit
- Forensic Audit
- Compliance Audit
- Internal Audit

### FINANCIAL STATEMENTS AUDIT

A financial statements audit is the examination of the financial statements of an organization as presented by the board of directors by someone independent of the organization ie. an external auditor.

This type of audit usually overs the basic set of financial statements (Balance Sheet, Income Statement, Statement of Cash Flows, Statement of Changes in Equity and notes to the financial statements)
A financial statement audit seeks to determine:

- Whether proper books have been kept and the financial statements are in agreement therewith.
- Whether the financial statements comply with relevant legislation and accounting standards eg IFRS.
- Whether the financial statements give a true and fair view of the state of the company’s affairs as at the year-end and of its results of operation and cash flows for the year.

**An overview of the Audit Function for a Financial Statements Audit**

![Audit Function Diagram]

- **Management**
  - Business Transactions
  - Prepares Financial Statements
  - Users

- **Auditor**
  - Obtains evidence
  - Tests assertions to criteria
  - Issues Audit report
  - Statutory Audit Report
  - Management Letter
Audit Conducted? Some matters of best practice

How is Financial Statements Audit Conducted? Some matters of best practice

The organisation’s management prepares draft financial statements. These are prepared in accordance with legal requirements and international financial reporting standards.

Auditors start their examination by gaining an understanding of the organisation’s activities, and considering the economic and industry issues that might have affected the business during the reporting period.

For each major item shown in the financial statements, auditors identify and assess any risks which could have a significant impact on the financial position or financial performance, and also some of the measures (called internal controls) that the organisation has put in place to mitigate those risks.

Auditors maintain independence from management and directors so that tests and judgments are made objectively. Auditors determine the type and extent of the audit procedures they will perform, depending on the risks and controls they have identified. The procedures may include:

- asking a range of questions - from formal written questions, to informal oral questions - of a range of individuals at the organisation
- examining financial and accounting records, other documents, and tangible items such as plant and equipment
- making judgments on significant estimates or assumptions that management made when they prepared the financial statement
- obtaining written confirmations of certain matters, eg, asking a debtor to confirm the amount of their debt with the organisation
- testing some of the organisation’s internal controls
- watching certain processes or procedures being performed.

Based on the risks and controls identified, auditors consider what management has done to ensure the financial statements are accurate, and examine supporting evidence.

When examining the financial statements, auditors follow auditing standards eg. Statements of Auditing Standards (SAS).

Closing / Exit Conference – Getting to the end of the audit, the auditors call for a closing or exit conference for the purpose of discussing their audit findings and obtaining any further explanations they consider necessary. This is to avoid any factual inaccuracies in their final report as well as ensuring that surprises are not sprang on the auditee.
Auditors then make a judgement as to whether the financial statements taken as a whole present a true and fair view of the results of operation and financial position of the organisation and its cash flows, and is in compliance with financial reporting standards and applicable laws.

- Finally, when the auditors complete their work they write the following audit reports:
  - Statutory audit report addressed to the shareholders in which the auditors express their audit opinion on the financial statements ie. unqualified audit opinion or qualified audit opinion.
  - Management report /letter addressed to the management of the organisation in which weaknesses in internal control as identified during the audit are reported with recommendations for improvement. Management responses to the audit findings are also included in the report.

**What External Auditors are not supposed to do.**

1. Audit other information provided to the members of the organisation, for example, the directors’ report.

2. Check every figure in the financial statement – audits are based on selective testing only.

3. Judge the appropriateness of the organisation’s business activities or strategies or decisions made by the directors.

4. Look at every transaction carried out by the organisation.

5. Test the adequacy of all of the organisation’s internal controls.

6. Comment to shareholders on the quality of directors and management, the quality of corporate governance or the quality of the organisation’s risk management procedures and controls.

7. Predict the future – The audit relates to a specific past accounting period. It does not judge what may happen in the future, and so cannot provide assurance that the organisation will continue in business indefinitely.

8. Be there all the time – The audit is carried out during a defined timeframe, and auditors are not at the organisation all the time. The prime purpose of the audit is to form an opinion on the information in the financial statements taken as a whole, and not to identify all possible irregularities. This means that although auditors are on the look-out for signs of potential material fraud, it is not possible to be certain that frauds will be identified.
An operational audit involves a systematic review of an organization’s activities, or a part of them, in relation to the efficient and effective use of resources. The purpose of an operational audit is:

- to assess performance,
- identify areas for improvement,
- and develop recommendations.

Sometimes this type of audit is referred to as a performance audit or management audit. Operational audits are generally more difficult to conduct than financial statements audits or compliance audits because it can be very difficult to identify objective, measurable criteria that can be used to assess effectiveness and efficiency.

Operational auditing has increased in importance in recent years, and it is likely that this trend will continue. With entities restructuring and downsizing, most facets of the entity are being evaluated. An example from the private sector would be when an entity employs auditors to assess the efficiency and effectiveness of the entity’s use of computer resources.

An operational Audit of a Central bank may have the following terms of reference and objectives:

- Determine the status of the Bank’s finances;
- Allow for remedial action to be taken and proactive measures to be put in place where necessary to bring the Bank’s accounting and reporting systems up to international standards;
- Serve as a guide to the Bank and the Government in the formulation of policy and decision making on monetary and fiscal matters;
- Improve the operational efficiency of the Bank;
- Enable the Bank track the cost of operations of the core departments.
- Identify internal control deficiencies and measurers required to improve management and control of the resources and assets of the Bank;
- Enable management to take steps to strengthen the internal audit department to ensure that the department performs effectively and efficiently; and
- Assist management to establish and implement an effective MIS for the above objectives.
Forensic Audit

Forensic Audit can be defined as the application of auditing skills to situations that have legal consequences.

A forensic audit is therefore a detailed investigation conducted for the purpose of detection of a wide variety of fraudulent activities.

Forensic auditors are employed by corporations, government agencies, public accounting firms, and consulting and investigative services firms. They are trained in detecting, investigating, and deterring fraud and white-collar crime. Some examples of situations where forensic auditors have been involved include:

- Analysing financial transactions involving unauthorised transfers of cash between companies
- Reconstructing incomplete accounting records to settle an insurance claim over inventory valuation.
- Proving money-laundering activities by reconstructing cash transactions.
- Embezzlement investigation and documentation, and negotiation of insurance settlements.
- Tracing funds or asset identification and recovery in a business fraud.
- Identification of the perpetrator of asset misappropriation.

Why do people commit fraud?

- Obvious lack of controls
- Management involvement
- Absence of corrective measures where fraud has been committed
- Legislative shortfalls
- Management condones it (no action taken)
- Absence of appropriate punishment
- Lack of fraud detection mechanisms
- Poor remuneration of employees
- Susceptibility of assets to fraud (cash vs. equipment)
- Excessive lifestyle
- Laissez-faire attitude by management
- Being in position of authority (ability to override controls)
COMPLIANCE AUDIT

A compliance audit determines the extent to which rules, policies, laws, covenants, or governmental regulations are followed by the entity being audited. For example, a company may be audited to determine whether corporate rules and policies are being followed by departments within the organization. The corporate rules and policies serve as the criteria for measuring the departments’ compliance. Another example is the examination of tax returns of individuals and companies by the Internal Revenue Service for compliance with the tax laws. In this example, the Income tax laws provide the criteria for measuring compliance.

INTERNAL AUDIT

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

The tasks of internal audit are:

♦ To examine the risks that the organisation faces.
♦ To review the adequacy of the controls in place to protect it from those risks
♦ To verify that the controls are working as intended
♦ To add value and improve the organization’s operations

Like external auditors, internal auditors must be objective and independent. To help ensure that objectivity and independence, it is suggested that the director of internal audit report directly to either the board of directors or the audit committee of the board or have free access to the board.

Internal auditors can be involved in all the other types of audits. They may conduct forensic audit within the entity if necessary. Additionally, they may assist the external auditors with the annual financial statement audit.

International Standards for the Professional Practice of Internal Auditing

In order to ensure that the internal audit function meets international best practice, it is necessary to adopt the International Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors.

The 2009 edition of the Standards is provided as follows:
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INTERNATIONAL STANDARDS FOR THE PROFESSIONAL PRACTICE OF INTERNAL AUDITING (STANDARDS)

Attribute Standards

1000 – Purpose, Authority, and Responsibility
The purpose, authority, and responsibility of the internal audit activity must be formally defined in an internal audit charter, consistent with the Definition of Internal Auditing, the Code of Ethics, and the Standards. The chief audit executive must periodically review the internal audit charter and present it to senior management and the board for approval.

Interpretation:
The internal audit charter is a formal document that defines the internal audit activity's purpose, authority, and responsibility. The internal audit charter establishes the internal audit activity's position within the organization; authorizes access to records, personnel, and physical properties relevant to the performance of engagements; and defines the scope of internal audit activities. Final approval of the internal audit charter resides with the board.

1000.A1 – The nature of assurance services provided to the organization must be defined in the internal audit charter. If assurances are to be provided to parties outside the organization, the nature of these assurances must also be defined in the internal audit charter.

1000.C1 – The nature of consulting services must be defined in the internal audit charter.

1010 – Recognition of the Definition of Internal Auditing, the Code of Ethics, and the Standards in the Internal Audit Charter
The mandatory nature of the Definition of Internal Auditing, the Code of Ethics, and the Standards must be recognized in the internal audit charter. The chief audit executive should discuss the Definition of Internal Auditing, the Code of Ethics, and the Standards with senior management and the board.

1100 – Independence and Objectivity
The internal audit activity must be independent, and internal auditors must be objective in performing their work.

Interpretation:
Independence is the freedom from conditions that threaten the ability of the internal audit activity or the chief audit executive to carry out internal audit responsibilities in an unbiased manner. To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity, the chief audit executive has direct and unrestricted access to senior management and the board. This can be achieved through a dual-reporting relationship.
Threats to independence must be managed at the individual auditor, engagement, functional, and organizational levels.
Objectivity is an unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they believe in their work product and that no
Objectivity requires that internal auditors do not subordinate their judgment on audit matters to others. Threats to objectivity must be managed at the individual auditor, engagement, functional, and organizational levels.

1110 – Organizational Independence
The chief audit executive must report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. The chief audit executive must confirm to the board, at least annually, the organizational independence of the internal audit activity.

1110.A1 – The internal audit activity must be free from interference in determining the scope of internal auditing, performing work, and communicating results.

1111 – Direct Interaction with the Board
The chief audit executive must communicate and interact directly with the board.

1120 – Individual Objectivity
Internal auditors must have an impartial, unbiased attitude and avoid any conflict of interest.

Interpretation:
Conflict of interest is a situation in which an internal auditor, who is in a position of trust, has a competing professional or personal interest. Such competing interests can make it difficult to fulfill his or her duties impartially. A conflict of interest exists even if no unethical or improper act results. A conflict of interest can create an appearance of impropriety that can undermine confidence in the internal auditor, the internal audit activity, and the profession. A conflict of interest could impair an individual's ability to perform his or her duties and responsibilities objectively.

1130 – Impairment to Independence or Objectivity
If independence or objectivity is impaired in fact or appearance, the details of the impairment must be disclosed to appropriate parties. The nature of the disclosure will depend upon the impairment.

Interpretation:
Impairment to organizational independence and individual objectivity may include, but is not limited to, personal conflict of interest, scope limitations, restrictions on access to records, personnel, and properties, and resource limitations, such as funding. The determination of appropriate parties to which the details of an impairment to independence or objectivity must be disclosed is dependent upon the expectations of the internal audit activity’s and the chief audit executive’s responsibilities to senior management and the board as described in the internal audit charter, as well as the nature of the impairment.

1130.A1 – Internal auditors must refrain from assessing specific operations for which they were previously responsible. Objectivity is presumed to be impaired if an internal auditor provides assurance services for an activity for which the internal auditor had responsibility within the previous year.
Assurance engagements for functions over which the chief audit executive has responsibility must be overseen by a party outside the internal audit activity.

1130.C1 – Internal auditors may provide consulting services relating to operations for which they had previous responsibilities.

1130.C2 – If internal auditors have potential impairments to independence or objectivity relating to proposed consulting services, disclosure must be made to the engagement client prior to accepting the engagement.

1200 – Proficiency and Due Professional Care
Engagements must be performed with proficiency and due professional care.

1210 – Proficiency
Internal auditors must possess the knowledge, skills, and other competencies needed to perform their individual responsibilities. The internal audit activity collectively must possess or obtain the knowledge, skills, and other competencies needed to perform its responsibilities.

Interpretation:
Knowledge, skills, and other competencies is a collective term that refers to the professional proficiency required of internal auditors to effectively carry out their professional responsibilities. Internal auditors are encouraged to demonstrate their proficiency by obtaining appropriate professional certifications and qualifications, such as the Certified Internal Auditor designation and other designations offered by The Institute of Internal Auditors and other appropriate professional organizations.

1210.A1 – The chief audit executive must obtain competent advice and assistance if the internal auditors lack the knowledge, skills, or other competencies needed to perform all or part of the engagement.

1210.A2 – Internal auditors must have sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organization, but are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud.

1210.A3 – Internal auditors must have sufficient knowledge of key information technology risks and controls and available technology-based audit techniques to perform their assigned work. However, not all internal auditors are expected to have the expertise of an internal auditor whose primary responsibility is information technology auditing.

1210.C1 – The chief audit executive must decline the consulting engagement or obtain competent advice and assistance if the internal auditors lack the knowledge, skills, or other competencies needed to perform all or part of the engagement.

1220 – Due Professional Care
Internal auditors must apply the care and skill expected of a reasonably prudent and competent internal auditor. Due professional care does not imply infallibility.
Internal auditors must exercise due professional care by considering the:

- Extent of work needed to achieve the engagement’s objectives;
- Relative complexity, materiality, or significance of matters to which assurance procedures are applied;
- Adequacy and effectiveness of governance, risk management, and control processes;
- Probability of significant errors, fraud, or noncompliance; and
- Cost of assurance in relation to potential benefits.

1220.A2 — In exercising due professional care internal auditors must consider the use of technology-based audit and other data analysis techniques.

1220.A3 — Internal auditors must be alert to the significant risks that might affect objectives, operations, or resources. However, assurance procedures alone, even when performed with due professional care, do not guarantee that all significant risks will be identified.

1220.C1 — Internal auditors must exercise due professional care during a consulting engagement by considering the:

- Needs and expectations of clients, including the nature, timing, and communication of engagement results;
- Relative complexity and extent of work needed to achieve the engagement’s objectives; and
- Cost of the consulting engagement in relation to potential benefits.

1230 — Continuing Professional Development
Internal auditors must enhance their knowledge, skills, and other competencies through continuing professional development.

1300 — Quality Assurance and Improvement Program
The chief audit executive must develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity.

Interpretation:
A quality assurance and improvement program is designed to enable an evaluation of the internal audit activity’s conformance with the Definition of Internal Auditing and the Standards and an evaluation of whether internal auditors apply the Code of Ethics. The program also assesses the efficiency and effectiveness of the internal audit activity and identifies opportunities for improvement.

1310 — Requirements of the Quality Assurance and Improvement Program
The quality assurance and improvement program must include both internal and external assessments.

1311 — Internal Assessments
Internal assessments must include:

- Ongoing monitoring of the performance of the internal audit activity; and
- Periodic reviews performed through self-assessment or by other persons within the organization with sufficient knowledge of internal audit practices.
Ongoing monitoring is an integral part of the day-to-day supervision, review, and measurement of the internal audit activity. Ongoing monitoring is incorporated into the routine policies and practices used to manage the internal audit activity and uses processes, tools, and information considered necessary to evaluate conformance with the Definition of Internal Auditing, the Code of Ethics, and the Standards. Periodic reviews are assessments conducted to evaluate conformance with the Definition of Internal Auditing, the Code of Ethics, and the Standards. Sufficient knowledge of internal audit practices requires at least an understanding of all elements of the International Professional Practices Framework.

1312 – External Assessments
External assessments must be conducted at least once every five years by a qualified, independent reviewer or review team from outside the organization. The chief audit executive must discuss with the board:

- The need for more frequent external assessments; and
- The qualifications and independence of the external reviewer or review team, including any potential conflict of interest.

Interpretation:
A qualified reviewer or review team consists of individuals who are competent in the professional practice of internal auditing and the external assessment process. The evaluation of the competency of the reviewer and review team is a judgment that considers the professional internal audit experience and professional credentials of the individuals selected to perform the review. The evaluation of qualifications also considers the size and complexity of the organizations that the reviewers have been associated with in relation to the organization for which the internal audit activity is being assessed, as well as the need for particular sector, industry, or technical knowledge. An independent reviewer or review team means not having either a real or an apparent conflict of interest and not being a part of, or under the control of, the organization to which the internal audit activity belongs.

1320 – Reporting on the Quality Assurance and Improvement Program
The chief audit executive must communicate the results of the quality assurance and improvement program to senior management and the board.

Interpretation:
The form, content, and frequency of communicating the results of the quality assurance and improvement program is established through discussions with senior management and the board and considers the responsibilities of the internal audit activity and chief audit executive as contained in the internal audit charter. To demonstrate conformance with the Definition of Internal Auditing, the Code of Ethics, and the Standards, the results of external and periodic internal assessments are communicated upon completion of such assessments and the results of ongoing monitoring are communicated at least annually. The results include the reviewer's or review team’s assessment with respect to the degree of conformance.
The chief audit executive may state that the internal audit activity conforms with the International Standards for the Professional Practice of Internal Auditing only if the results of the quality assurance and improvement program support this statement.

1322 – Disclosure of Nonconformance
When nonconformance with the Definition of Internal Auditing, the Code of Ethics, or the Standards impacts the overall scope or operation of the internal audit activity, the chief audit executive must disclose the nonconformance and the impact to senior management and the board.

Performance Standards 2000 – Managing the Internal Audit Activity
The chief audit executive must effectively manage the internal audit activity to ensure it adds value to the organization.

Interpretation:
The internal audit activity is effectively managed when:
- The results of the internal audit activity’s work achieve the purpose and responsibility included in the internal audit charter;
- The internal audit activity conforms with the Definition of Internal Auditing and the Standards; and
- The individuals who are part of the internal audit activity demonstrate conformance with the Code of Ethics and the Standards.

2010 – Planning
The chief audit executive must establish risk-based plans to determine the priorities of the internal audit activity, consistent with the organization’s goals.

Interpretation:
The chief audit executive is responsible for developing a risk-based plan. The chief audit executive takes into account the organization’s risk management framework, including using risk appetite levels set by management for the different activities or parts of the organization. If a framework does not exist, the chief audit executive uses his/her own judgment of risks after consultation with senior management and the board.

2010.A1 – The internal audit activity’s plan of engagements must be based on a documented risk assessment, undertaken at least annually. The input of senior management and the board must be considered in this process.

2010.C1 – The chief audit executive should consider accepting proposed consulting engagements based on the engagement’s potential to improve management of risks, add value, and improve the organization’s operations. Accepted engagements must be included in the plan.

2020 – Communication and Approval
The chief audit executive must communicate the internal audit activity’s plans and resource requirements, including significant interim changes, to senior management
2030 – Resource Management
The chief audit executive must ensure that internal audit resources are appropriate, sufficient, and effectively deployed to achieve the approved plan.

Interpretation:
Appropriate refers to the mix of knowledge, skills, and other competencies needed to perform the plan. Sufficient refers to the quantity of resources needed to accomplish the plan. Resources are effectively deployed when they are used in a way that optimizes the achievement of the approved plan.

2040 – Policies and Procedures
The chief audit executive must establish policies and procedures to guide the internal audit activity.

Interpretation:
The form and content of policies and procedures are dependent upon the size and structure of the internal audit activity and the complexity of its work.

2050 – Coordination
The chief audit executive should share information and coordinate activities with other internal and external providers of assurance and consulting services to ensure proper coverage and minimize duplication of efforts.

2060 – Reporting to Senior Management and the Board
The chief audit executive must report periodically to senior management and the board on the internal audit activity’s purpose, authority, responsibility, and performance relative to its plan. Reporting must also include significant risk exposures and control issues, including fraud risks, governance issues, and other matters needed or requested by senior management and the board.

Interpretation:
The frequency and content of reporting are determined in discussion with senior management and the board and depend on the importance of the information to be communicated and the urgency of the related actions to be taken by senior management or the board.

2100 – Nature of Work
The internal audit activity must evaluate and contribute to the improvement of governance, risk management, and control processes using a systematic and disciplined approach.

2110 – Governance
The internal audit activity must assess and make appropriate recommendations for improving the governance process in its accomplishment of the following objectives:
- Promoting appropriate ethics and values within the organization;
- Ensuring effective organizational performance management and accountability;
2110.A1 – The internal audit activity must evaluate the design, implementation, and effectiveness of the organization’s ethics-related objectives, programs, and activities.

2110.A2 – The internal audit activity must assess whether the information technology governance of the organization sustains and supports the organization’s strategies and objectives.

2110.C1 – Consulting engagement objectives must be consistent with the overall values and goals of the organization.

2120 – Risk Management
The internal audit activity must evaluate the effectiveness and contribute to the improvement of risk management processes.

Interpretation:
Determining whether risk management processes are effective is a judgment resulting from the internal auditor’s assessment that:

- Organizational objectives support and align with the organization’s mission;
- Significant risks are identified and assessed;
- Appropriate risk responses are selected that align risks with the organization’s risk appetite; and
- Relevant risk information is captured and communicated in a timely manner across the organization, enabling staff, management, and the board to carry out their responsibilities.
- Risk management processes are monitored through ongoing management activities, separate evaluations, or both.

2120.A1 – The internal audit activity must evaluate risk exposures relating to the organization’s governance, operations, and information systems regarding the:
- Reliability and integrity of financial and operational information.
- Effectiveness and efficiency of operations.
- Safeguarding of assets; and
- Compliance with laws, regulations, and contracts.

2120.A2 – The internal audit activity must evaluate the potential for the occurrence of fraud and how the organization manages fraud risk.

2120.C1 – During consulting engagements, internal auditors must address risk consistent with the engagement’s objectives and be alert to the existence of other significant risks.

2120.C2 – Internal auditors must incorporate knowledge of risks gained from consulting engagements into their evaluation of the organization’s risk management processes.
2130 – Control
The internal audit activity must assist the organization in maintaining effective controls by evaluating their effectiveness and efficiency and by promoting continuous improvement.

2130.A1 – The internal audit activity must evaluate the adequacy and effectiveness of controls in responding to risks within the organization’s governance, operations, and information systems regarding the:
- Reliability and integrity of financial and operational information;
- Effectiveness and efficiency of operations;
- Safeguarding of assets; and
- Compliance with laws, regulations, and contracts.

2130.A2 – Internal auditors should ascertain the extent to which operating and program goals and objectives have been established and conform to those of the organization.

2130.A3 – Internal auditors should review operations and programs to ascertain the extent to which results are consistent with established goals and objectives to determine whether operations and programs are being implemented or performed as intended.

2130.C1 – During consulting engagements, internal auditors must address controls consistent with the engagement’s objectives and be alert to significant control issues.

2130.C2 – Internal auditors must incorporate knowledge of controls gained from consulting engagements into evaluation of the organization’s control processes.

2200 – Engagement Planning
Internal auditors must develop and document a plan for each engagement, including the engagement’s objectives, scope, timing, and resource allocations.

2201 – Planning Considerations
In planning the engagement, internal auditors must consider:
- The objectives of the activity being reviewed and the means by which the activity controls its performance;
- The significant risks to the activity, its objectives, resources, and operations and the means by which the potential impact of risk is kept to an acceptable level;
- The adequacy and effectiveness of the activity’s risk management and control processes compared to a relevant control framework or model; and
- The opportunities for making significant improvements to the activity’s risk management and control processes.

2201.A1 – When planning an engagement for parties outside the organization, internal auditors must establish a written understanding with them about objectives, scope,
2201.C1 — Internal auditors must establish an understanding with consulting engagement clients about objectives, scope, respective responsibilities, and other client expectations. For significant engagements, this understanding must be documented.

2210 – Engagement Objectives
Objectives must be established for each engagement.

2210.A1 — Internal auditors must conduct a preliminary assessment of the risks relevant to the activity under review. Engagement objectives must reflect the results of this assessment.

2210.A2 — Internal auditors must consider the probability of significant errors, fraud, noncompliance, and other exposures when developing the engagement objectives.

2210.A3 — Adequate criteria are needed to evaluate controls. Internal auditors must ascertain the extent to which management has established adequate criteria to determine whether objectives and goals have been accomplished. If adequate, internal auditors must use such criteria in their evaluation. If inadequate, internal auditors must work with management to develop appropriate evaluation criteria.

2210.C1 — Consulting engagement objectives must address governance, risk management, and control processes to the extent agreed upon with the client.

2220 – Engagement Scope
The established scope must be sufficient to satisfy the objectives of the engagement.

2220.A1 — The scope of the engagement must include consideration of relevant systems, records, personnel, and physical properties, including those under the control of third parties.

2220.A2 — If significant consulting opportunities arise during an assurance engagement, a specific written understanding as to the objectives, scope, respective responsibilities, and other expectations should be reached and the results of the consulting engagement communicated in accordance with consulting standards.

2220.C1 — In performing consulting engagements, internal auditors must ensure that the scope of the engagement is sufficient to address the agreed-upon objectives. If internal auditors develop reservations about the scope during the engagement, these reservations must be discussed with the client to determine whether to continue with the engagement.

2230 – Engagement Resource Allocation
Internal auditors must determine appropriate and sufficient resources to achieve engagement objectives based on an evaluation of the nature and complexity of each engagement, time constraints, and available resources.
2240.A1 – Work programs must include the procedures for identifying, analyzing, evaluating, and documenting information during the engagement. The work program must be approved prior to its implementation, and any adjustments approved promptly.

2240.C1 – Work programs for consulting engagements may vary in form and content depending upon the nature of the engagement.

2300 – Performing the Engagement
Internal auditors must identify, analyze, evaluate, and document sufficient information to achieve the engagement’s objectives.

2310 – Identifying Information
Internal auditors must identify sufficient, reliable, relevant, and useful information to achieve the engagement’s objectives.

Interpretation:
Sufficient information is factual, adequate, and convincing so that a prudent, informed person would reach the same conclusions as the auditor. Reliable information is the best attainable information through the use of appropriate engagement techniques. Relevant information supports engagement observations and recommendations and is consistent with the objectives for the engagement. Useful information helps the organization meet its goals.

2320 – Analysis and Evaluation
Internal auditors must base conclusions and engagement results on appropriate analyses and evaluations.

2330 – Documenting Information
Internal auditors must document relevant information to support the conclusions and engagement results.

2330.A1 – The chief audit executive must control access to engagement records. The chief audit executive must obtain the approval of senior management and/or legal counsel prior to releasing such records to external parties, as appropriate.

2330.A2 – The chief audit executive must develop retention requirements for engagement records, regardless of the medium in which each record is stored. These retention requirements must be consistent with the organization’s guidelines and any pertinent regulatory or other requirements.

2330.C1 – The chief audit executive must develop policies governing the custody and retention of consulting engagement records, as well as their release to internal and external parties. These policies must be consistent with the organization’s guidelines and any pertinent regulatory or other requirements.
Engagements must be properly supervised to ensure objectives are achieved, quality is assured, and staff is developed.

**Interpretation:**
The extent of supervision required will depend on the proficiency and experience of internal auditors and the complexity of the engagement. The chief audit executive has overall responsibility for supervising the engagement, whether performed by or for the internal audit activity, but may designate appropriately experienced members of the internal audit activity to perform the review. Appropriate evidence of supervision is documented and retained.

**2400 – Communicating Results**
Internal auditors must communicate the engagement results.

**2410 – Criteria for Communicating**
Communications must include the engagement’s objectives and scope as well as applicable conclusions, recommendations, and action plans.

**2410.A1** – Final communication of engagement results must, where appropriate, contain internal auditors’ overall opinion and/or conclusions.

**2410.A2** – Internal auditors are encouraged to acknowledge satisfactory performance in engagement communications.

**2410.A3** – When releasing engagement results to parties outside the organization, the communication must include limitations on distribution and use of the results.

**2410.C1** – Communication of the progress and results of consulting engagements will vary in form and content depending upon the nature of the engagement and the needs of the client.

**2420 – Quality of Communications**
Communications must be accurate, objective, clear, concise, constructive, complete, and timely.

**Interpretation:**
Accurate communications are free from errors and distortions and are faithful to the underlying facts. Objective communications are fair, impartial, and unbiased and are the result of a fair-minded and balanced assessment of all relevant facts and circumstances. Clear communications are easily understood and logical, avoiding unnecessary technical language and providing all significant and relevant information. Concise communications are to the point and avoid unnecessary elaboration, superfluous detail, redundancy, and wordiness. Constructive communications are helpful to the engagement client and the organization and lead to improvements where needed. Complete communications lack nothing that is essential to the target audience and include all significant and relevant information and observations to support recommendations and conclusions. Timely communications are opportune and
expedient, depending on the significance of the issue, allowing management to take appropriate corrective action.

2421 – Errors and Omissions
If a final communication contains a significant error or omission, the chief audit executive must communicate corrected information to all parties who received the original communication.

2430 – Use of “Conducted in Conformance with the International Standards for the Professional Practice of Internal Auditing”
Internal auditors may report that their engagements are “conducted in conformance with the International Standards for the Professional Practice of Internal Auditing”, only if the results of the quality assurance and improvement program support the statement.

2431 – Engagement Disclosure of Nonconformance
When nonconformance with the Definition of Internal Auditing, the Code of Ethics or the Standards impacts a specific engagement, communication of the results must disclose the:
- Principle or rule of conduct of the Code of Ethics or Standard(s) with which full conformance was not achieved;
- Reason(s) for nonconformance; and
- Impact of nonconformance on the engagement and the communicated engagement results.

2440 – Disseminating Results
The chief audit executive must communicate results to the appropriate parties.

Interpretation:
The chief audit executive or designee reviews and approves the final engagement communication before issuance and decides to whom and how it will be disseminated.

2440.A1 – The chief audit executive is responsible for communicating the final results to parties who can ensure that the results are given due consideration.

2440.A2 – If not otherwise mandated by legal, statutory, or regulatory requirements, prior to releasing results to parties outside the organization the chief audit executive must:
- Assess the potential risk to the organization;
- Consult with senior management and/or legal counsel as appropriate; and
- Control dissemination by restricting the use of the results.

2440.C1 – The chief audit executive is responsible for communicating the final results of consulting engagements to clients.

2440.C2 – During consulting engagements, governance, risk management, and control issues may be identified. Whenever these issues are significant to the organization, they must be communicated to senior management and the board.
The chief audit executive must establish and maintain a system to monitor the disposition of results communicated to management.

2500.A1 – The chief audit executive must establish a follow-up process to monitor and ensure that management actions have been effectively implemented or that senior management has accepted the risk of not taking action.

2500.C1 – The internal audit activity must monitor the disposition of results of consulting engagements to the extent agreed upon with the client.

2600 – Resolution of Senior Management’s Acceptance of Risks
When the chief audit executive believes that senior management has accepted a level of residual risk that may be unacceptable to the organization, the chief audit executive must discuss the matter with senior management. If the decision regarding residual risk is not resolved, the chief audit executive must report the matter to the board for resolution.
value is provided by improving opportunities to achieve organizational objectives, identifying operational improvement, and/or reducing risk exposure through both assurance and consulting services.

**Adequate Control**
Present if management has planned and organized (designed) in a manner that provides reasonable assurance that the organization’s risks have been managed effectively and that the organization’s goals and objectives will be achieved efficiently and economically.

**Assurance Services**
An objective examination of evidence for the purpose of providing an independent assessment on governance, risk management, and control processes for the organization. Examples may include financial, performance, compliance, system security, and due diligence engagements.

**Board**
A board is an organization’s governing body, such as a board of directors, supervisory board, head of an agency or legislative body, board of governors or trustees of a nonprofit organization, or any other designated body of the organization, including the audit committee to whom the chief audit executive may functionally report.

**Charter**
The internal audit charter is a formal document that defines the internal audit activity’s purpose, authority, and responsibility. The internal audit charter establishes the internal audit activity’s position within the organization; authorizes access to records, personnel, and physical properties relevant to the performance of engagements; and defines the scope of internal audit activities.

**Chief Audit Executive**
Chief audit executive is a senior position within the organization responsible for internal audit activities. Normally, this would be the internal audit director. In the case where internal audit activities are obtained from external service providers, the chief audit executive is the person responsible for overseeing the service contract and the overall quality assurance of these activities, reporting to senior management and the board regarding internal audit activities, and follow-up of engagement results. The term also includes titles such as general auditor, head of internal audit, chief internal auditor, and inspector general.

**Code of Ethics**
The Code of Ethics of The Institute of Internal Auditors (IIA) are Principles relevant to the profession and practice of internal auditing, and Rules of Conduct that describe behavior expected of internal auditors. The Code of Ethics applies to both parties and entities that provide internal audit services. The purpose of the Code of Ethics is to promote an ethical culture in the global profession of internal auditing.
Compliance
Adherence to policies, plans, procedures, laws, regulations, contracts, or other requirements.

Conflict of Interest
Any relationship that is, or appears to be, not in the best interest of the organization. A conflict of interest would prejudice an individual’s ability to perform his or her duties and responsibilities objectively.

Consulting Services
Advisory and related client service activities, the nature and scope of which are agreed with the client, are intended to add value and improve an organization’s governance, risk management, and control processes without the internal auditor assuming management responsibility. Examples include counsel, advice, facilitation, and training.

Control
Any action taken by management, the board, and other parties to manage risk and increase the likelihood that established objectives and goals will be achieved. Management plans, organizes, and directs the performance of sufficient actions to provide reasonable assurance that objectives and goals will be achieved.

Control Environment
The attitude and actions of the board and management regarding the significance of control within the organization. The control environment provides the discipline and structure for the achievement of the primary objectives of the system of internal control. The control environment includes the following elements:

- Integrity and ethical values.
- Management’s philosophy and operating style.
- Organizational structure.
- Assignment of authority and responsibility.
- Human resource policies and practices.
- Competence of personnel.

Control Processes
The policies, procedures, and activities that are part of a control framework, designed to ensure that risks are contained within the risk tolerances established by the risk management process.

Engagement: A specific internal audit assignment, task, or review activity, such as an internal audit, control self-assessment review, fraud examination, or consultancy. An engagement may include multiple tasks or activities designed to accomplish a specific set of related objectives.

Engagement Objectives: Broad statements developed by internal auditors that define intended engagement accomplishments.

Engagement Work Program: A document that lists the procedures to be followed during an engagement, designed to achieve the engagement plan.
Fraud
Any illegal act characterized by deceit, concealment, or violation of trust. These acts are not dependent upon the threat of violence or physical force. Frauds are perpetrated by parties and organizations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantage.

Governance: The combination of processes and structures implemented by the board to inform, direct, manage, and monitor the activities of the organization toward the achievement of its objectives.

Impairment: Impairment to organizational independence and individual objectivity may include personal conflict of interest, scope limitations, restrictions on access to records, personnel, and properties, and resource limitations (funding).

Independence: The freedom from conditions that threaten objectivity or the appearance of objectivity. Such threats to objectivity must be managed at the individual auditor, engagement, functional, and organizational levels.

Information Technology Controls
Controls that support business management and governance as well as provide general and technical controls over information technology infrastructures such as applications, information, infrastructure, and people.

Information Technology Governance
Consists of the leadership, organizational structures, and processes that ensure that the enterprise’s information technology sustains and supports the organization’s strategies and objectives.

Internal Audit Activity
A department, division, team of consultants, or other practitioner(s) that provides independent, objective assurance and consulting services designed to add value and improve an organization’s operations. The internal audit activity helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of governance, risk management and control processes.

International Professional Practices Framework
The conceptual framework that organizes the authoritative guidance promulgated by The IIA. Authoritative Guidance is comprised of two categories – (1) mandatory and (2) strongly recommended.

Must: The Standards use the word “must” to specify an unconditional requirement.

Objectivity
An unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they have an honest belief in their work product and that no
significant quality compromises are made. Objectivity requires internal auditors not to subdivide their judgment on audit matters to others.

**Residual Risk**
The risk remaining after management takes action to reduce the impact and likelihood of an adverse event, including control activities in responding to a risk.

**Risk**
The possibility of an event occurring that will have an impact on the achievement of objectives. Risk is measured in terms of impact and likelihood.

**Risk Appetite:** The level of risk that an organization is willing to accept.

**Risk Management**
A process to identify, assess, manage, and control potential events or situations to provide reasonable assurance regarding the achievement of the organization’s objectives.

**Should:** The Standards use the word “should” where conformance is expected unless, when applying professional judgment, circumstances justify deviation.

**Significance**
The relative importance of a matter within the context in which it is being considered, including quantitative and qualitative factors, such as magnitude, nature, effect, relevance, and impact.

Professional judgment assists internal auditors when evaluating the significance of matters within the context of the relevant objectives.

**Standard**
A professional pronouncement promulgated by the Internal Audit Standards Board that delineates the requirements for performing a broad range of internal audit activities, and for evaluating internal audit performance.

**Technology-based Audit Techniques**
Any automated audit tool, such as generalized audit software, test data generators, computerized audit programs, specialized audit utilities, and computer-assisted audit techniques (CAATs).