

CORE PRINCIPLES OF EFFECTIVE INTERNAL AUDIT

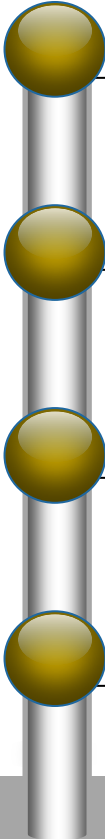
PREPARED FOR BAHAMAS INSTITUTE OF
INTERNAL AUDITORS

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BY

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- 
- Effective Auditing
 - Independence of Internal Auditor
 - Management Support of Internal Audit
 - Ethics and Competency

INTERNAL AUDIT EFFECTIVENESS

- The concept of internal auditing effectiveness has been considered subjective and less studied in the auditing literature.
- This subjectivity can be associated with a lack of an approved criteria for its measurement.
- Institutions should examine the internal audit effectiveness to accomplish the primary objectives of internal auditing function (IAF).

- Prior researchers have perceived internal auditing effectiveness as the ability of the IAF to achieve its objectives and goals.
- Based on the approved definition of the Institute of Internal Auditors (IIA), the goal of IAF is **to add value to and improve the processes of an institution.**

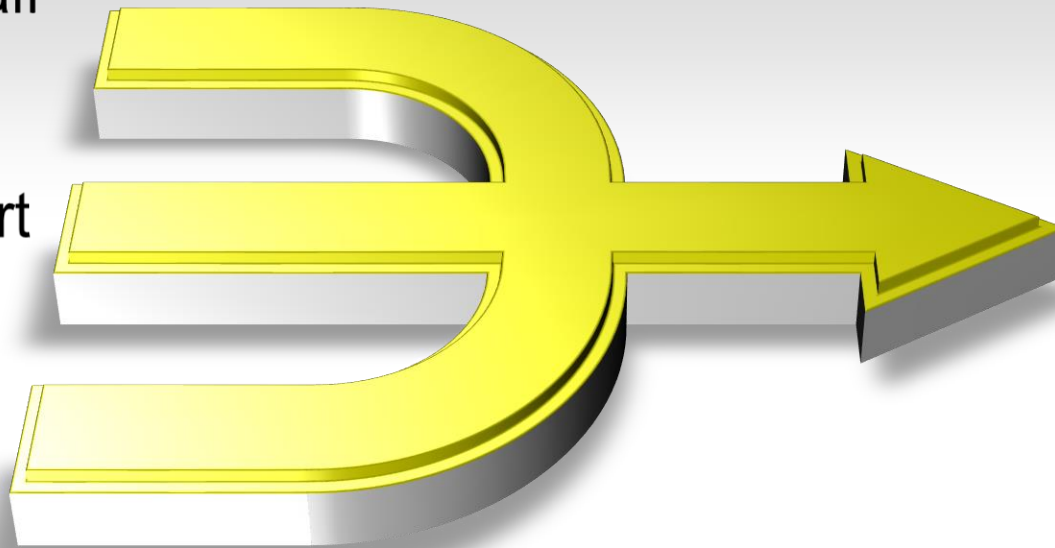
- Therefore, not all IAFs are effective **but only those that create value to the processes of the institution** (Dellai & Omri, 2016).
- The most prominent claim that has been observed from the previous studies is that internal auditing aims to add value to an institution by bringing effectiveness on **risk management, governance, and internal control processes.**

AUDIT EFFECTIVENESS EQUALS VALUE ADDED

Skilled Audit Staff

BOD Support

Effect of Audit
Reporting



**ADDED
VALUE**

- Other researchers have attested that internal auditing creates a unique value by identifying the weaknesses in institutional processes and providing the necessary recommendations to be implemented by senior management to improve the audited processes.
- However, arguments were noted in the literature regarding the appropriateness of the criteria to correctly measure internal auditing effectiveness.

- Also, the effectiveness of internal auditing function has been denoted as an issue of great concern to many researchers, internal auditing professionals and auditing clients.
- It is **value-driven** because it was designed to help its clients **to improve internal effectiveness of business operations** and it remains a huge challenge when internal auditing functions do not serve their ascribed purpose.

CORE PRINCIPLES OF EFFECTIVE AUDITING



1. IA should demonstrate independence.
2. IA should have the support of management.
3. IA should demonstrate good ethics.
4. IA department should only undertake assignments within their competencies.

- The implementation of recommendations by internal auditors, reliance placed by external auditors on the work of internal auditors, international standards for the professional practice of internal auditing, satisfaction of the needs of the auditee, and improvement of auditee performance was among the discussed criteria for measuring internal auditing effectiveness.

- In addition to the four components mentioned for internal audit effectiveness, researchers have identified 8 core areas, that if correctly measured, gives a possible measure of audit effectiveness.
- These include the following:

EFFECTIVE AUDITING SPIDER



ASSESSING AUDIT EFFECTIVENESS

- There are several determinants already identified in literature that could affect the effectiveness of internal auditing to successfully realize its core values.
- However, only limited research has been conducted on the validation of these determinants.

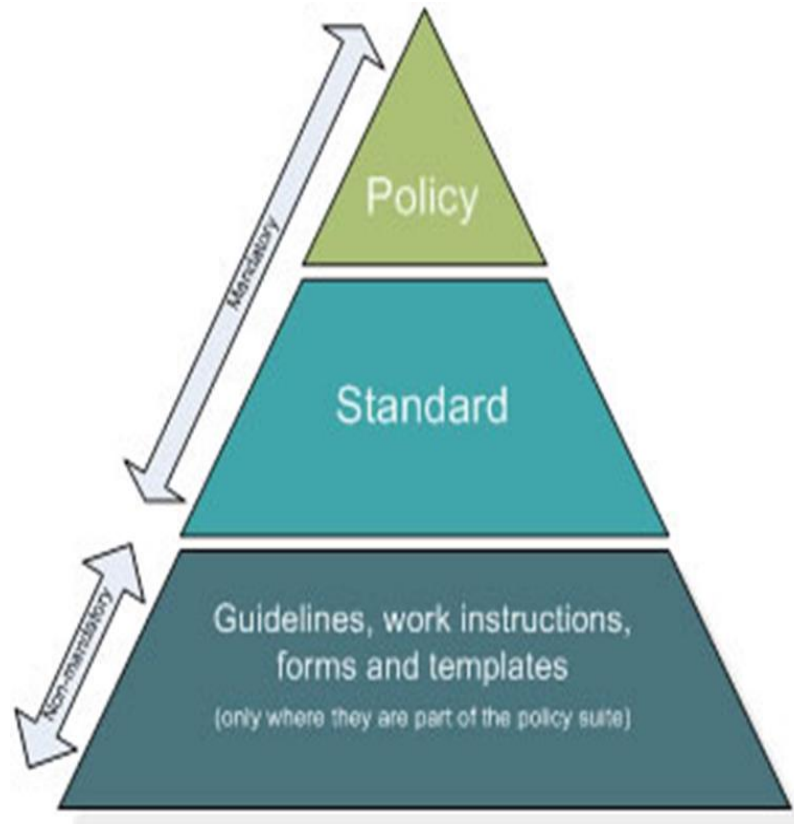
- Accordingly, not all internal auditing functions can help institutions to achieve their objectives, but only those that are effective.
- The effectiveness of internal auditing has been defined by Dittenhofer (2001), as the potential of the internal auditing function to achieve its set objectives.

- Some of the research suggested that measurement criteria of internal auditing effectiveness may differ from one institution to the other, which means that **there are no common standard criteria of internal auditing effectiveness.**
- **Measurement of audit effectiveness is a subjective matter, using qualitative methodology.**

IA STANDARD, GUIDELINES, AND CODES OF ETHICS

What are Policies , Standards, Guidelines and Procedures?

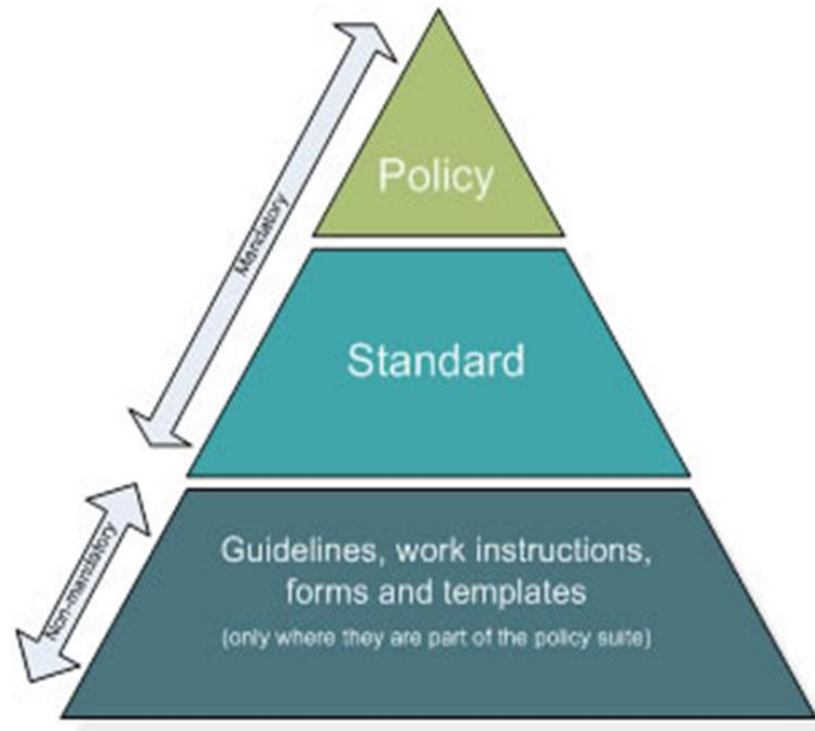
- ❖ **Policies** are high-level documents that represent the corporate philosophy of an organization.
- ❖ **Procedures** are documented, defined steps for achieving policy objectives. They must be derived from the parent policy and must implement the spirit (intent) of the policy statement.



IA STANDARD, GUIDELINES, AND CODES OF ETHICS

What are Policies ,
Standards, Guidelines and
Procedures?

- ❖ **Standards** are specific mandatory controls.
- ❖ **Guidelines** are recommendations and best practices.



IIA members and certification holders shall:

- ❖ Support the implementation of, and encourage compliance with appropriate standards.
- ❖ Perform their duties with objectivity, due diligence and professional care.
- ❖ Serve in the interest of stakeholders in a lawful manner.
- ❖ Maintain the privacy and confidentiality of information.

IIA members and certification holders shall:

- ❖ Maintain competency in their respective fields and agree to undertake only those activities they can reasonably expect to complete with the necessary skills, knowledge and competence.
- ❖ Inform appropriate parties of the results of work performed, including the disclosure of all significant facts known to them that, if not disclosed, may distort the reporting of the results.
- ❖ Support the professional education of stakeholders.

AUDIT CHARTER

- ❖ Its a high level document.
- ❖ Since it is an high level document it is approved by highest authority that is board of directors and Audit committee if it exists.
- ❖ Since it is a high level document approved by board of directors changes are done only after significant change in business or threat scenario (not frequently).
- ❖ Since changes are not done frequently it describe the overall authority, scope, and responsibilities of the audit function.
- ❖ Overall an IS audit charter establishes the role of the audit function. This is one of the **foundations of IA'S POWER.**

ABC Corp needs to update its audit charter so what should an organization's IA charter specify :

- A. Short- and long-term plans for IA engagements.
- B. Objectives and scope of IA engagements.
- C. Detailed training plan for the IA staff.
- D. Role of the IA function.

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- D. **Role of the IA function.**

Overall an IA charter establishes the role of the internal audit function

An audit charter should:

- A. Be dynamic and change often to coincide with the changing nature of technology and the audit profession.
- B. Clearly state audit objectives for, and the delegation of, authority to the maintenance and review of internal controls.
- C. Document the audit procedures designed to achieve the planned audit objectives.
- D. Outline the overall authority, scope and responsibilities of the audit function.

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In an Organization Audit charter is approved by:

- A. Board of directors or Audit Committee.
- B. Board of directors or Senior Management.
- C. Board of directors and Audit Committee.
- D. Senior Management and Audit Committee.

AUDIT CHARTER QUESTIONS

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Which of the following outlines the overall authority to perform an IS Audit.

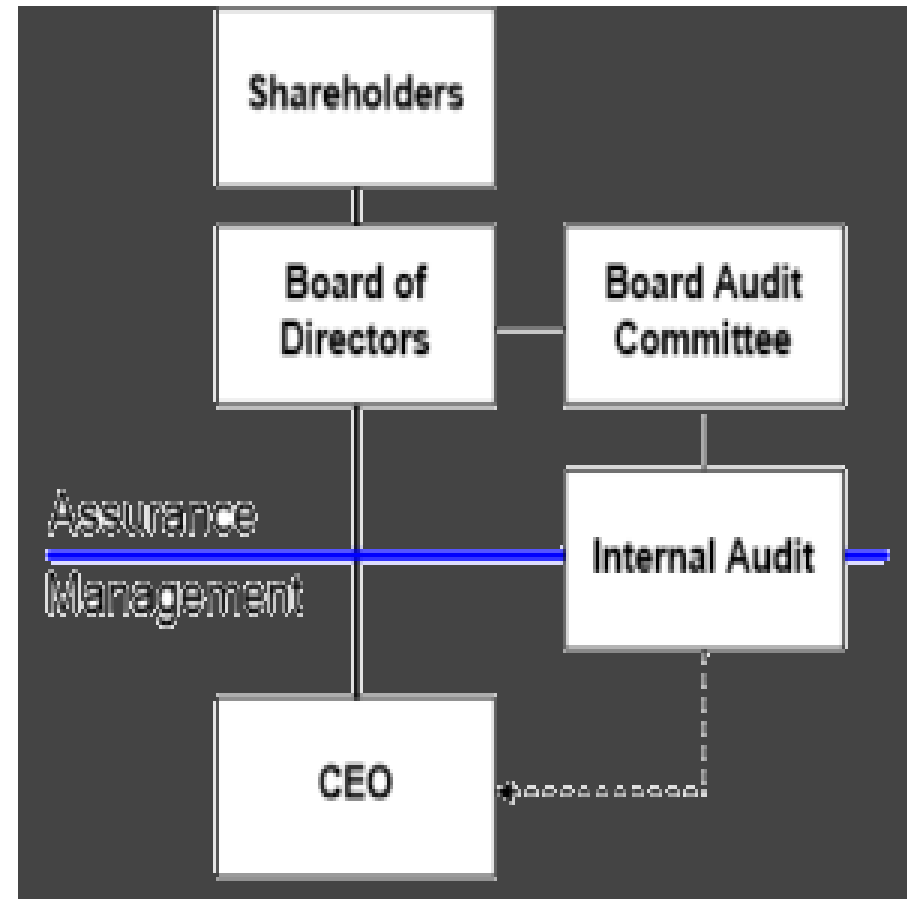
- A. The audit scope, with goals and objectives.
- B. A request from Management to perform an audit.
- C. The approved audit charter.
- D. The approved audit schedule

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MANAGEMENT OF INTERNAL AUDIT FUNCTION

- ❖ The IS audit function should be managed and led in a manner preserving audit independence and competence and should ensure value-added contributions to senior management in the efficient management of business units to achieve the business objectives.
- ❖ An internal auditor must be **technically competent**, having the skills and knowledge necessary to perform audit work.



INDEPENDENCE

The international standards for the professional practice of internal auditing (ISPPIA) necessitate that:

- An internal auditing unit of an institution **should be independent and that internal auditors be objective while performing their internal auditing activities.**
- Standard 1100 recommends that to ensure an appropriate level of independence and objectivity of internal auditors, the **head of internal auditing unit should report administratively to senior management and functionally to the audit committee of the board of directors.**

- Internal auditors should have unrestricted access to records, personnel and departments, avoid any conflict of interest, and not perform non-audit activities.
- Furthermore, Standard 1111 emphasizes that **the access of chief audit executive to the board of directors and senior management be unlimited to allow for full independence** of the department.

- Therefore, researchers concluded that **independence of internal audit function is the most crucial determinant that contributes to the effectiveness of internal auditing in comparison** to other determinants.
- A lack of independence in internal auditing is a critical hiccup to the satisfactory performance of an internal auditing unit (Salehi, 2016). Ali (2018); Coetzee & Erasmus (2017) have equally attested that **independence of internal auditing is the foundation for effective internal auditing processes.**

AUDIT FUNCTION QUESTIONS

Internal Audit function of ABC Corp should report to.

- A. Board of directors or Audit Committee.
- B. Senior Management and Audit Committee.
- C. Head of respective departments.
- D. CEO.

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A long-term IT employee with a strong technical background and broad managerial experience has applied for a vacant position in the IA department. Determining whether to hire this individual for this position should be primarily based on the individual's experience and:

- A. Length of service because this will help insure technical competence.
- B. Age, because training in audit techniques may be impractical.
- C. Knowledge of internal systems because this will bring enhanced credibility to the audit function.
- D. Ability of an internal auditor, to be independent of existing internal relationships.

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Independence should be continually assessed by the auditor and management. This assessment should consider such factors as change in personal relationships, financial interests and prior job assignments and responsibilities.

An IS auditor plays an important role in improving the quality and control of internal controls and information systems in an organization. Elements of quality control with respect to an audit engagement include the following:

QUALITY ASSURANCE AND INDEPENDENCE

Point 1

Leadership responsibilities for quality in audits.

Point 2

Ethical requirements (including independence).

Point 3

Acceptance and continuance of client relationships and specific audit engagements.

QUALITY ASSURANCE AND INDEPENDENCE

Point 4

Assignment of engagement teams.

Point 5

Engagement performance (including consultation, resolution of differences of opinion and engagement quality control review).

Point 6

Monitoring

- Recent academic studies that have examined **internal audit quality** as an **independent variable**, along with **internal audit effectiveness** as a **dependent variable**, found that there is a positive relationship between the two variables (George et al., 2015; Rudhani et al., 2017).
- Competent internal audit staff improve the quality of audit work by **correctly justifying the internal audit findings**, issuing **accurate auditing reports**, improving **their communication with external auditors** and achieving internal audit objectives.

AUDIT INDEPENDENCE QUESTIONS

Which of the following factors relating to audit independence is LEAST important to a successful and effective Internal Audit?

- A. Personnel policies that forbid immediate relatives of Internal Auditors to work for the company.
- B. Internal Auditor's independence to plan and pursue work within the scope of a written internal audit mandate.
- C. Internal Auditor's access to and support from top management for internal audit plans and programs.
- D. Internal Auditor's access to information concerning all areas of the organization.

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An internal audit department, that organizationally reports exclusively to the Chief Financial Officer (CFO) rather than to an Audit Committee, is MOST likely to:

- A. Have its audit independence questioned.
- B. Report more business-oriented and relevant findings.
- C. Enhance the implementation of the auditor's recommendations.
- D. Result in more effective action being taken on the recommendations.

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Information Systems (IS) auditors who have participated in the development of an application system might have their independence impaired if they:

- A. Perform an application development review.
- B. Recommend control and other system enhancements.
- C. Perform an independent evaluation of the application after its implementation.
- D. Are involved actively in the design and implementation of the application system.

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An IS auditor is assigned to perform a post implementation review of an application system. Which of the following situations may have impaired the independence of the IS auditor? The IS auditor:

- A. Implemented a specific control during the development of the application system.
- B. Designed an embedded audit module exclusively for auditing the application system.
- C. Participated as a member of the application system project team, but did not have operational responsibilities.
- D. Provided consulting advice concerning application system best practices.

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COMPETENCE

- Alzeban & Gwilliam (2014) have associated competence with the level of education, working experience in a field of internal auditing, professional qualifications, and training, all of which assist auditors to add value and improve institutional performance.
- The general experience of internal auditors relates to the years of experience, skills, knowledge, training, and expertise (Shamki & Alhajri, 2017).

- This requirement is consistent with internal auditing Standard 1210, which states that “*internal auditors must possess high skills, knowledge and competencies to perform their responsibilities*” (Institute of Internal Auditors, 2017). Furthermore, Demeke et al. (2020) have associated auditing experience with skills and knowledge that an auditor develops with long practices in the internal auditing field.

- Auditors should stay sharp with IT techniques.
- Hence, the IIA standard 1210.A3 states that
“Internal auditors must have sufficient knowledge of key IT risks, controls and availability technology driven audit techniques to perform the assigned work. However, not all internal auditors are expected to have the expertise of an internal auditor whose primary responsibility is information technology auditing” (Institute of Internal Auditors, 2017).

- Management support for effective internal auditing is considered as one of the most significant determinants by almost all studies of internal audit effectiveness.
- Interaction between the chief audit executive and senior management is a prime determinant of internal auditing effectiveness.
- Moreover, Mensah et al. (2020) found a positive correlation between management support and internal auditing **effectiveness** with the recommendation that **more management support for internal audit functions is needed for the acquisition of adequate resources, appropriate skills, experience, consistent development of staff.**

- Erasmus & Coetzee (2018) have argued sternly that effective functioning of an internal audit function **relies on the effectiveness of audit committee and that of audit committee relies on effective internal audit function.**
- Alzeban & Gwilliam (2014) further emphasizes that the **two parties should have a strong working relationship** to assist internal audit to protect institutional value from risk, by providing risk-based assurance, advice, and insight to the institution.

From the modern internal auditing perspective, which one of the following statements represents the most important benefit of an internal audit department to management?

- A. Assurance that published financial statements are correct.
- B. Assurance that fraudulent activities will be detected.
- C. Assurance that the organization is complying with legal requirements.
- D. Assurance that there is reasonable control over day-to-day operations.
- E. A reduction of external audit activities could be accomplished.

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While assisting the external auditor in the performance of substantive tests or tests of controls, the internal auditor should:

- A. Establish limits of materiality that are below the usual limits set by the external auditor.
- B. Establish limits of materiality that are above the usual limits set by the external auditor.
- C. Be supervised by the external auditor.
- D. Be independent of the external auditor.
- E. Strive to reduce the cost of the external auditor.

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Which one of the following items is included in an operational audit but is not required in a financial audit conducted by an external auditor?

- A. Planning and control over the work done by an audit team.
- B. Supervision of the audit team's activities and output.
- C. Fact-finding, analysis, and documentation.
- D. Recommendations for improvement.
- E. Reporting on the findings.

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SAMPLE METHODOLOGY FOR ASSESSING AUDIT EFFECTIVENESS

- The study on audit effectiveness will be qualitative because the measurements are subjective, (what a good job you are doing, does management support you, how is the relationship with external auditors, etc.).
- Use a methodology similar to risk assessment. Identify qualitative components, code them, then apply a quantitative value.

SAMPLE METHODOLOGY FOR ASSESSMENT

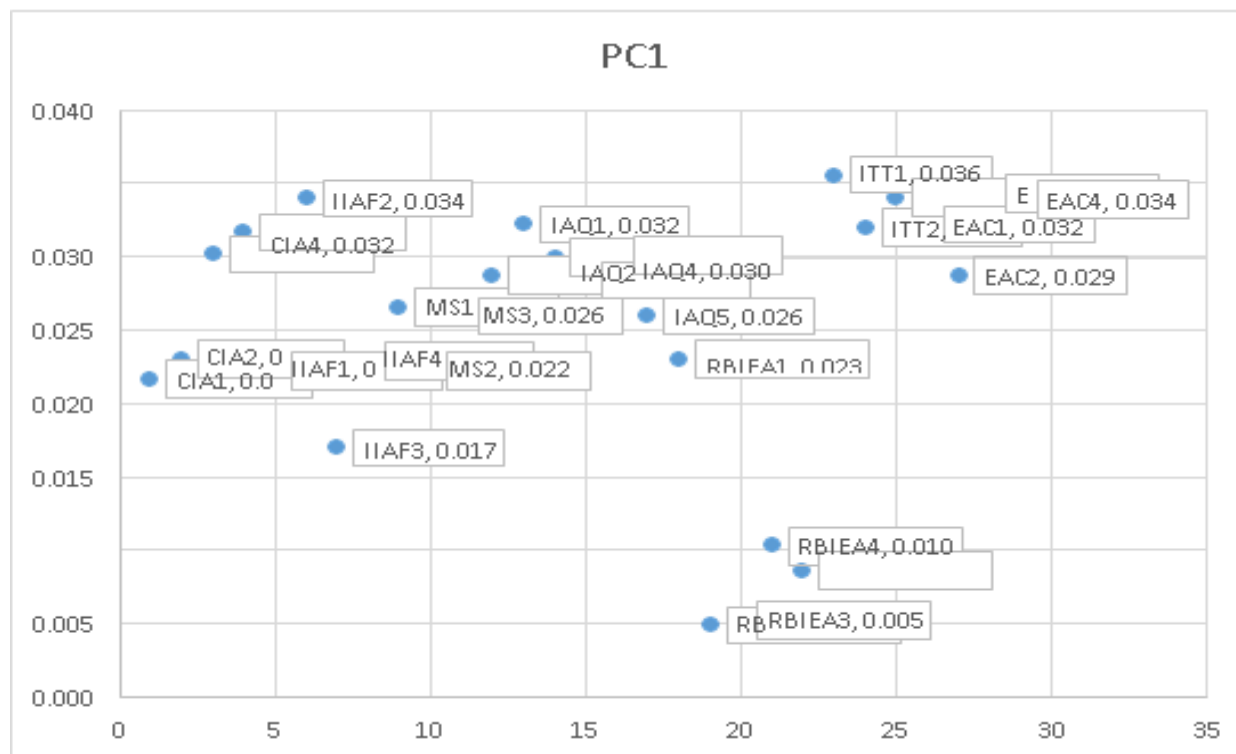
SAMPLE QUALITATIVE CODING FOR DETERMINING INTERNAL AUDIT EFFECTIVENESS			
Number	Category	Description	Code
3	<u>Competence of Internal Auditors</u>	Internal auditors possess enough experience	CIA1
		Required skills to perform internal audits	CIA2
		Relevant qualifications in auditing	CIA3
		Ability to use computerised data tools	CIA4
4	<u>Independence of IAF</u>	Free access to departments and workers	IIAF1
		Participation in development of processes	IIAF2
		Impartial unbiased attitude	IIAF3
		Non-performance of non-audit services	IIAF4
5	<u>Management Support</u>	Support internal audit to perform its services	MS1
		Involvement in internal audit plan	MS2
		IAF provide reports to senior management	MS3
		IAF is reasonable funded	MS4
6	<u>Internal Audit Quality</u>	Accomplishment of internal audit objectives	IAQ1
		Efficiency in internal audit work	IAQ2
		Justification of internal audit findings	IAQ3
		Accuracy of internal audit reports	IAQ4
		Minimised duplication of work among auditors	IAQ5
7	<u>Relationship between internal and external auditors</u>	Support among both parties	RBIEA1
		Good attitude towards internal auditors	RBIEA2
		Discussion of plans among both parties	RBIEA3
		Reliance on internal auditor's work	RBIEA4
		Share of audit working papers	RBIEA5
8	<u>Effective Audit Committee</u>	Approval of CAE appointment and removal	EAC1
		Mutual relationship with internal auditors	EAC2
		Support of good governance	EAC3
		Strengthens management of risk	EAC4

- One way to proceed is by using the designated coding, apply a quantitative value similar to a **HEAT MAP** applying subjective value to the categories.
- Another way is by using statistical scatter graphs to plot the effectiveness performance.
- Draw a Heat Map with colour coding, with green being most effective, red is least effective, and yellow is in between,
- A sample heat map is shown below.

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E F F E C T I V E N S S	6				1		1, 2	Low	<div>Less Effective</div> <div>Effective</div>
	5			3		4	3, 4	Modest	
	4				2		5, 6	Modest	
	3		3			5, 6	1, 2	Moderate	
	2						3, 4	Moderate	
	1						5, 6	Moderate	
	1		4					High	
	IMPACT	1	2	3	4	5	6		

INTERNAL AUDITING DETERMINANT SCATTER PLOT



CONCLUSION

- Audit Independence is a fundamental element of effective Internal Audit.
- **The Audit Charter determines the overall power given to the Internal Audit Department.**
- The IAF should have the support of the BOD and the Audit Committee in terms of resources, both human and technical.
- The Auditor should demonstrate high ethical standards.

CONCLUSION

- There is no one way to measure the effectiveness of internal audit because all organizations are different.
- The assessment will be subjective.
- A suggested way is to code the different inputs of effectiveness, then use a modified Heat Map to assess effectiveness.
- Or use statistical scatter graph to plot the measurements of effectiveness.

CONCLUSION

- The most influential determinants of internal auditing effectiveness can serve as a useful barometer to identify weaknesses and strengths of internal auditing function or outsourced auditing firm.
- Moreover, the results of this lecture afford a baseline for continued research for the management to help identify and test the degree of significance of their performance indicators.

Any Questions?

THANK YOU CARD



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