NORTHERN ILLINOIS UNIVERSITY

Current Issues in Internal Auditing

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by

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### Honors Thesis Abstract

**Thesis Submission Form**

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**Abstract:**

This Capstone project examines current internal auditing issues including behavioral factors, electronic data processing auditing, environmental auditing, ethics, fraud, operational auditing, outsourcing, and reporting. Information for the Capstone was gathered from a literature review utilizing the publications *Internal Auditor* and *Internal Auditing*. Each article is individually summarized, and each auditing issue is summarized.
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Topical Summaries
Behavioral

Internal auditing is a dynamic, ever-changing profession. To achieve success in the field, auditors need to understand their personal weaknesses and strengths, and how to use those weaknesses and strengths to their advantage.

One of the most essential skills an auditor should possess is the ability to communicate. Internal auditors deal with many different types of people--factory workers, middle management, clerical staff, CEOs. The ability to successfully communicate with each and every person is required. Most recent graduates are not able to communicate at the level employers require. For this reason, employers are urging the educational community to offer written and oral communication classes for students. Some schools, such as Northern Illinois University, have developed additional required English classes tailored specifically for accounting students. More schools will probably implement these classes if employers begin requiring writing samples as part of the interviewing process.

Auditors gather information from interviewing people, not just from financial statements. In order for auditors to obtain accurate information, they need to be able to conduct effective interviews. Conducting effective interviews involves knowing which questions to ask, how to ask the questions, and how to interpret verbal and nonverbal responses. Effective interviewers begin with specific objectives, outlines, and background information on the subject areas. Then, they create a comfortable interview setting and evaluate responses to interview questions. Interviewers word questions carefully so they do not bias the interviewee’s response. During the interview, auditors may become suspicious that the interviewee may be involved in some wrongdoing or may have knowledge of wrongdoing. The interviewer should be suspicious of this if the interviewee gives inconsistent answers to questions, acts nervous, avoids looking the interviewer in the eye, or hesitates before answering questions. Auditors should always approach interviews with an attitude of "professional skepticism."

Listening is obviously a very large part of an auditor's job. People will open up and supply more information to an effective listener. Body posture, facial expression, and voice tone often determine whether someone is considered a "good" listener. Effective listeners lean toward the speaker, face the speaker, and appear relaxed throughout the communication process. People are perceived as effective listeners if they smile at the speaker, alter facial expressions to respond to the person who is talking, and

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nod to confirm points the speaker makes. Listeners should maintain eye contact with the speaker without staring and politely ask questions. Auditees will respect and confide in an auditor who is an effective listener.

Internal auditors experience a lot of inherent stress. This stress is caused by travel, time-pressure, interaction with many types of people, and auditee perception of auditors. Offering a training class with travel tips and helping auditors with personal errands will reduce travel stress. Allowing sufficient breaks throughout the day can help alleviate stress caused by time-pressure. Also, schedules need to be developed with reasonable time estimates, and flexible to allow auditors to spend extra time with audit issues if they need to. Improving communication skills can help reduce the stress caused by interacting with many different types of people. Auditors can learn to interact and respond positively to all types of people. Auditors can also help change their "watchdog" reputation. If auditors help auditees understand that auditing helps solve problems and that auditors are not a threat to the auditees, auditees will happily receive the auditors.

Auditees see auditors as watchdogs without personalities. Many auditors believe this role is necessary to remain independent. Many auditors also become carried away with trying to find issues that they forget their real mission--to help solve problems. Auditors should listen to the auditees so they can help the auditees understand why and how issues arise. Then, auditors should help the auditees solve any current issues and teach the auditees how to prevent future issues. Auditors need to remember what purpose they serve. Uncovering issues does not help the organization unless the auditor also attempt to prevent the same issues from occurring in the future.

As the business environment changes, auditors should be aware that they are not guaranteed job security. Audit departments can be downsized and reduced. To prepare for downsizing, auditors need to keep their skills on the cutting edge. Networking, building portfolios, and marketing yourself are essential for finding jobs. Auditors should prepare for their next job before they lose the current one.

Internal auditing is a dynamic, exciting career. Many factors determine success, but above all, communications skills are the most important. As with any career, auditors should educate themselves about changes in the profession and prepare themselves for their next challenge.
EDP Auditing

In order to effectively perform internal audits, internal auditors need to have at least a basic understanding of information systems. Internal auditors do not have to audit the software itself, but they do have to audit financial numbers and internal controls that are affected by the software. Basic system knowledge is essential since companies have many different types of systems.

Internal auditors should be concerned about software theft. Software theft occurs when individuals make unauthorized copies of software. Software purchasers are usually allowed to make one copy of their software—for emergency back-up only. Individuals who violate the copyright laws may be prosecuted with criminal penalties and/or civil action. If employees within a company illegally copy and distribute software, the company is also legally liable for damages. Software creators may be awarded damages that include profits the company earned while using illegal software. Software theft is a serious problem in the United States.

Windows has become the operating environment used by most companies, and its use is constantly increasing. More and more companies are converting to a client/server computer system. Client/server systems consist of one computer which processes information (the client) and other computers which serve as data input and output points (the servers). Companies implementing client/server systems usually have increasing information systems budgets. Lack of qualified personnel is considered to be the greatest obstacle in implementing client/server systems. Internal auditors should be aware of the consequences surrounding system development.

Internal auditors should obtain information about the Chief Information Officer turnover rate. The CIO turnover rate has consistently increased over the past few years. Internal auditors may want to investigate the turnover rate in their companies and determine why the turnover rate is lower or higher than the average.

The amount of staff in the information services area has remained fairly stable. Recently, more staff has been allocated to communication and network management, and at least half of the staff develops and maintains applications. Internal auditors should determine if the information systems area is understaffed since understaffing could cause internal control problems within the system.

Internal auditors do have a responsibility for systems development. As systems are developed,
internal auditors should help develop adequate internal controls and ensure that the systems are auditable. Improving auditability and designing internal controls after the system has been developed is very difficult and expensive. Internal auditors may experience resistance as members of the system development team. If internal auditors help with system development, some auditors believe that they will compromise their independence. By serving as consultants for system development, internal auditors avoid the independence issue.

Internal auditors need to investigate system security to ensure that data integrity is maintained. Data encryption and digital signatures help maintain data integrity. Data encryption changes information so that unauthorized users cannot easily decipher it. The authorized receiver decodes information using a "key." The key is either a single private key, known only to the sender and receiver, or a combination of a public and private key. With the combination of keys, everyone knows the public key, but each private key is individually known.

Digital signatures maintain the integrity of electronic signatures. When a document is signed, the computer develops a code to attach to the signature. The code is based on the document contents and the signature so that if the document or signature is altered, the code will also change. When the message is received, the computer authenticates the electronic signature by comparing the code to a hash value.

Data encryption and digital signatures maintain data integrity. However, the benefits of implementing these system elements may not outweigh the costs. Internal auditors should carefully research each alternative before suggesting that either be implemented. Also, if either method is implemented, the internal auditor should ensure that effective controls are established for maintaining the public and private keys. If either key is lost, the data will be useless to the receiver and sender.

The electronic data processing environment is constantly changing to meet user demands. Internal auditors need to understand the current system and foresee changes which may improve the system. Internal auditors should also realize that they need to be current in technology changes since the auditing environment is constantly changing. As systems change and develop, internal auditors should ensure that information systems maintain adequate internal controls and are auditable.
Environmental Auditing

Environmental liabilities pose a serious threat to companies. Although auditors do not have the technical expertise to determine whether a company is actually committing an environmental crime, they do need to have enough expertise to know when a potential environmental problem exists. Since environmental liabilities normally cost companies large amounts of money, auditors need to know when an environmental liability may be occurring and whether an accrual should be made for the possible liability.

Most companies are conducting environmental audits. Usually a department with technical expertise in dealing with environmental issues (environmental audit) performs the audits. However, the internal audit department may also be involved in the audits. The internal audit department may be responsible for applying audit procedures during the audits, providing resources for the other department to complete the audits, and/or auditing the other department. In some companies, internal audit performs environmental audits with help from an environmental engineer. In other companies, an internal auditor helps the environmental audit group.

What can internal auditors do to help their companies avoid costly environmental liabilities? Internal auditors can be aware of current and pending legislation, environmental issues plaguing the company, and potential issues which could turn into environmental problems. Performing audits with awareness of environmental concerns will also help organizations.

Companies must understand the Superfund law. The Superfund law places responsibility for waste with the company that generated the waste. If the company that generated the waste cannot financially support their environmental obligations, the responsibility then falls on the current owner of the property. Any other company involved with waste contaminated property (one example would be insurance companies) may also be held liable for cleanup expenses. Even company management may be held personally liable for cleanup costs in some states. To effectively avoid liability under the Superfund law, companies should avoid dealing with any type of waste. Since this is impossible, companies need to manage their waste very closely.

Companies perform environmental audits for three important reasons: to monitor compliance with legal regulations, to assess environmental legal liability, and to gain a competitive advantage.
Ensuring compliance with legal regulations is extremely important since government agencies, state governments, the federal government, and private citizens may sue companies for noncompliance with regulations and/or neglecting moral obligations. Companies have been assessed astronomical fines for environmental damage.

How can companies gain a competitive advantage from following environmental regulations? If a company implements a regulation more efficiently and effectively than its competition, the company will gain a competitive advantage. Customers react positively to companies who support the "green movement." Company image improves when it takes responsibility for environmental concerns. Also, companies may discover that producing products efficiently under the environmental regulations is more cost efficient in the long run. Internal auditors can monitor the company's progress in adopting environmental regulations and make suggestions when they feel processes need to be changed to account for environmental issues.

Internal auditors should possess basic knowledge on ways to reduce environmental liability. One way to reduce the liability is to reduce the amount of waste the company produces. Some companies implement waste management programs to monitor environmental issues. Internal auditors should encourage companies to identify environmental costs and expenditures--both costs of compliance and noncompliance.

Internal auditors should ensure that their companies have adequate environmental insurance. Insurance companies can help cover the costs of environmental noncompliance; however, insurance companies often try to deny environmental claims. Insurance policies should be kept in a safe place where they are easily accessible. Invoices, canceled checks, and old records and reports can also serve as evidence of coverage for claims which occurred years ago. Insurance companies can be a valuable source of help in identifying and correcting potential problems.

Environmental concerns have increased dramatically in the past few years. Internal auditors need to be able to identify potential environmental problems and offer viable solutions to the problems. Companies that perform environmental audits have the potential for creating a competitive advantage. The most effective way to avoid environmental liabilities is to curb the problem at the source--when the waste is produced. Companies can also reduce their liabilities by performing voluntary cleanup.
Ethics

Ethics play an important role in every profession, but especially in auditing. Unethical auditors could cause havoc in the financial world. Internal auditors must understand the rules and regulations that govern their activities and the consequences of unethical decisions. Internal auditors must also understand their role in the organization and how decisions affect the organization as a whole.

The Institute of Internal Auditors (IIA) govern the internal auditing profession. Internal auditors must also follow generally accepted accounting practices (GAAP) when GAAP regulations affect financial reporting. Internal auditors are obligated to serve their company, not external parties. Therefore, the IIA does not require internal auditors to report incidents of wrongdoing to outside parties since this would not help advance the organization. Internal auditors owe their organizations loyalty which requires that they do not report wrongdoing directly or indirectly to outside parties. As auditors work on an audit, they need to be aware that anything they write in the work papers can be subpoenaed by a court of law. Therefore, any incriminating evidence should be handled by the organization's lawyers and should not be reported in the work papers.

The IIA Code of Ethics specifically prohibits auditors from whistle blowing unless the auditor has been given permission by management or is required by law. Whistle blowing is considered to be the unauthorized disclosure of wrongdoing to external parties. Whistle blowing does not include informing management of internal wrongdoing. Internal auditors are required to report internal wrongdoing to management and/or the audit committee.

Why do people commit unethical acts? Most unethical acts are committed and tolerated because they are "for the good of the business." The most common types of wrongdoing are employee theft, mismanagement, and waste. The most successful companies usually have stronger codes of ethics, and companies without strong ethical practices are usually unsuccessful. Most perpetrators of fraud are first time offenders who would not normally commit a crime, but they made a bad decision and were caught. Most people know what is right and wrong, but they do not make decisions based on that knowledge. Organizations need to have a strong code of ethics to deter unscrupulous behavior. The ethical tone needs to be set by the board of directors. Internal auditors should ensure compliance with the company's ethical code.
What do companies consider ethical issues to be? Most ethical issues involve direct public damage to the company's reputation. These ethical issues include harassment, environmental concerns, and employee conflicts of interest. Issues such as unreasonable compensation and workplace safety do not qualify as ethical issues in the business world. When analyzing ethical issues, internal auditors should determine whether the issue could cause harm, who the issue would harm, and how to deal with the situation.

The IIA has developed a Code of Ethics for internal auditors to follow. However, only members of the IIA and people using the IIA trademark need to follow the code. What do internal auditors do when their company's ethical code conflicts with the IIA Code of Ethics? Most auditors view the company code as more important than the IIA Code of Ethics. All auditors do not strictly adhere to the IIA Code of Ethics. Evidence suggests that auditors adhere to standards pertaining to personal integrity more than to standards pertaining to the quality of service.

Who has the responsibility for establishing and maintaining ethics in an organization? The board of directors should establish ethics, but internal auditors should monitor and maintain ethical standards. Internal auditors should be ethical role models for the organization. Leaders in the internal audit profession believe that ethics can be taught to children but not adults. Ethical beliefs are instilled during childhood. They also believe that the difference between right and wrong can be taught. Can ethics be audited? The industry leaders believe that the results of ethical decisions can be audited, but the decisions themselves cannot be audited.

Ethics are an integral part of earning respect for the internal audit profession. Maintaining and promoting ethical behavior is a cornerstone for building trust and loyalty for the profession. Internal auditors should support creating a strong code of ethics and even an Ethics Committee within their organizations. Internal auditors should be aware that their job is to uncover wrongdoing in the organization and report it to management. They should not violate their duty of loyalty and report wrongdoing to external parties. If the auditor feels he/she is compromising his/her own ethics by allowing an action to continue, the auditor should resign instead of blowing the whistle on the organization.
Internal auditors are the main defense against perpetrators of fraud. Most internal auditors spend the majority of their time evaluating internal controls to reduce the risk of fraud. Companies lose millions of dollars a year because of fraud. If internal auditors understand why fraud occurs, they will be able to detect and prevent it from occurring.

Fraud will occur if companies do not set strict ethical guidelines. Companies must very clearly prohibit fraud committed against the company and for the benefit of the company. Management should set the ethical tone from the top and supply resources to fight fraud. Internal auditors should urge managers to support the fight against fraud, especially if a company does not have stringent fraud policies. Responsibility for teaching managers how to detect and prevent fraud belongs to the internal auditors.

Internal auditors detect fraud by following five general steps. First, auditors should know specific fraud exposures and symptoms of fraud. Then, auditors should design audits to uncover fraud symptoms. Auditors should investigate all instances where fraud symptoms are found. Auditors should understand that they are responsible for uncovering fraud; therefore, schedules and budgets should provide auditors with the ability to investigate fraud symptoms. Auditors cannot win the fight against fraud if the do not have adequate resources to fight it. Management cannot lead a successful fight against fraud if perpetrators are not punished to the fullest extent. The most efficient way to deter fraud is to make the consequences unsavory. After fraud investigations are complete, the auditors should assess and attempt to solve internal control weaknesses.

The Statement on Internal Auditing Standards No. 3 requires internal auditors to evaluate internal controls in relation to fraud, examine fraud symptoms, and report fraud internally. Internal auditors are prohibited from reporting suspected fraud to external parties, even the external auditors. Fraud would occur less often if the internal auditors could report to the external auditors since fraud perpetrators may believe that management "sweeps fraud under the rug" by not notifying external parties.

Internal auditors may be hesitant to report fraud. Some auditors still believe that they do not share the responsibility for discovering fraud. But, more importantly, some auditors believe that their jobs are at stake if they do report fraud. If management does not fully support the fight against fraud,
they may not want internal auditors to report suspected fraud. Laws should protect auditors who fulfill their professional obligations by reporting fraud. However, some auditors do lose their jobs by reporting fraud. Obviously, if their jobs are at stake, auditors will be more hesitant to report fraud.

Most people who commit fraud are first time offenders who would not normally commit a crime. However, the offenders saw an opportunity to commit fraud and they were able to rationalize committing fraudulent acts. Organizations can never be completely fraud-free; however, they can implement internal controls and ethics policies to deter most fraud. Internal controls must be constantly monitored since fraud occurs despite the existence of controls. When people commit fraud, they usually compromise the existing internal controls.

Fraud hotlines effectively prevent fraud. Usually either the internal audit department or the security department implements fraud hotlines. Hotlines allow employees to anonymously report fraud and other wrongdoing. Since fraud hotlines do not receive an unreasonable amount of calls, all calls, within reason, can be investigated. For hotlines to be successful, they must be heavily advertised within the organization. If hotlines are continuously advertised, employees will know that management takes the fight against fraud seriously. Also, by advertising the hotline, employees will be more apt to notice fraudulent activities. Offering monetary incentives to report fraud does not improve the effectiveness of fraud hotlines. Fraud hotlines can uncover external fraud also. Some insurance companies have set up fraud hotlines for their customers to use to prevent fraudulent insurance claims.

Many people will admit their fraudulent crimes if they are asked. With fraud assessment questioning (FAQ), interviewers can obtain information about fraudulent activities. If certain questions are asked in the correct order, most individuals will admit to committing or knowing of fraud. Since most people do not naturally tell lies, FAQ draws information from people without them knowing that they are providing it. FAQ usually uncovers evidence of fraud. Then, with further investigation, auditors will discover if fraud was actually committed.

Fraud is a serious issue in most companies. Internal auditors need to know what measures they can undertake to help fight fraud. Having top management support the fight against fraud is the most effective resource. However, auditors need to look for fraud in their audits. Then, they need to educate management on how to prevent and detect fraud.
Operational Auditing

Most internal audit departments spend the majority of their time performing operational audits. Internal audit departments use many different methods to complete operational audits. Which method is most effective depends upon company policies, culture, and procedures.

What factors determine whether an internal auditor will be successful? Do internal auditors need to be experts in the fields they audit or can they have only a general working knowledge? Is technical expertise more important than auditing knowledge in operational audits? Generally, internal auditors need an accounting background to perform successful operational audits. Internal auditors only need to familiarize themselves with the areas they audit, although any additional knowledge is definitely beneficial.

Companies approach operational audits in a variety of ways including: the commonsense audit approach, the risk assessment approach, and a cultural approach. The audit approach should be tailor-made for each individual audit.

The commonsense audit approach (CAA) was devised to provide a simple outline of steps to follow in operational audits. First, audit objectives should be determined before the audit begins. Audit objectives usually deal with determining internal control effectiveness. The second step is to gain a broad understanding of the audit area including external issues, risks, and exposures. Then, an audit plan and schedule are developed. As the audit process begins, auditors should document their understanding of the internal control structure and test whether the controls are working. In most operational audits, tests of controls must be devised from scratch because operational systems are rarely similar. After performing tests of controls, auditors should identify missing controls by comparing the actual control structure to what the control structure should be. Then, the missing controls should be evaluated on a cost/benefit basis to determine if controls should be added or changed. The final step in the audit process is the audit report.

The risk assessment approach focuses on determining how to select operational audit topics in order to reduce the organization's overall risk. First, auditors must recognize audit opportunities. If an auditor believes a particular area looks suspicious, he/she may want to investigate it further. Then, the auditor determines the specific focus of the audit while considering operating efficiency, effectiveness,
and economy. After the auditor determines the assertions to be tested, he/she evaluates the consequences of false assertions and assesses the possibility of a false assertion. Assertions are what the auditor believes should be occurring. After determining whether the assertion should be audited, the auditor needs to determine whether the assertion can be audited with the resources available. The auditor should weigh the costs and benefits of testing each assertion. Even if the audit topic is determined to be an audit issue, the topic must be weighed in importance according to all other audit topics. Obviously, resources should be invested in only the most important audits.

How do organizations utilize a cultural approach in operational auditing? A cultural approach includes examining specific processes and causes of problems. The cultural approach focuses on why problems occur, not on discovering problems. Cultural audits focus on how systems adapt to their surroundings. Since problems develop from overall system adaptations, cultural audits focus on discovering adaptations and evaluating the adaptation effectiveness. Audit techniques in cultural audits include numerous interactions with employees. Auditors interview employees, observe employee activities, and participate in employee activities. The cultural audit approach assimilates the working environment into audit findings and suggestions. This approach is more favorable with auditees since they believe the auditors try to understand why problems occur. The auditors are not passing judgement on the auditees.

Many organizations are focusing on responding to customer requests. Therefore, internal auditors are attempting to supply what their customers want, not what the auditors believe is appropriate. One way to respond more effectively to customer requests is to focus on audit outcomes, not audit processes. In the past, auditors have performed specific steps in each audit. However, the steps did not vary according to the audit. If the auditors had focused on the final product and devised steps to deliver a specific product instead of using predetermined audit steps, the customer would be much happier with the outcome.

No matter which audit approach is used, operational audits will be successful if auditors focus on providing quality output in response to customer needs. Successful internal auditors have technical expertise in the areas of auditing and/or accounting, and they obtain a general working knowledge of audit areas prior to beginning an audit.
Outsourcing

Outsourcing has become a hot topic in internal auditing recently. Many companies have begun to outsource their internal audit function. The outsourcing trend has caused great concern throughout the internal auditing profession. Most internal audit functions are outsourced to public accounting firms. Although public accounting firms are obvious choices for performing the internal audits, whether the outsourcing is effective and efficient is questionable.

One responsibility being outsourced is reporting on internal controls. The importance of reporting on internal controls has grown in recent years. Today, internal auditors spend much of their time evaluating internal controls. The main issue in outsourcing internal control responsibilities is the public accounting firm's legal liability. If a public accounting firm issues a clean audit report on the client's internal controls and the controls are discovered to be faulty, the public accounting firm may be liable for any losses relating to inadequate internal controls after issuing a clean audit report.

Public accounting firms claim that they are more able to provide experienced auditors for internal audits. However, professionals employed by public accounting firms rarely possess technical expertise in internal auditing. The high turnover rate in public accounting causes the average audit staff member to remain relatively inexperienced and new. If public accounting firms assign new employees to internal audits, the staff will not be experienced.

Public accounting firms may not want to perform the internal audit function. The cultures in internal and external auditing are vastly different. In fact, some external auditors may not respect internal auditing as a profession. If a culture difference exists and if external auditors do not respect internal auditing, it will be difficult for public accounting firms to find experienced people willing to perform internal audit engagements. The staff in public accounting firms may not want to perform internal audit engagements because their careers may be hampered by accepting the engagements. People on the "fast track" in public accounting do not perform internal audits. Also, when a staff member participates in internal audit engagements, he/she will have more difficulty advancing out of the public accounting profession.

One of the most important problems with outsourcing involves core competency. Many organizations are finding that it is essential to have an on-going internal audit function. Some internal audit
departments believe their mission is to provide the organization with an ambitious, high-talent pool of accountants who are knowledgeable about all the organization's businesses. Not only do internal auditor have broad knowledge about the organization, but they understand the organization's culture and objectives. Internal auditors are experts in their company's internal controls. External auditors have difficulty duplicating this expertise.

Public accounting firms win outsourcing contracts through better prices. External auditors claim that they can perform audits with less overall cost than the internal audit function requires. Internal auditors, without a doubt, are more expensive per hour. However, they are less expensive overall. External auditors may be able to perform internal audits more cheaply than internal auditors, but what happens when the company requests special reports or engagements? Quite often, external auditors will recoup internal audit costs by charging more for special requests. Also, over time the price of regular internal audit engagements will increase. Any initial cost benefits from outsourcing may disappear within a couple of years.

Organizations should consider audit rights before they outsource any function. Audit rights allow external auditors to audit the function even though the client does not "own" the function. Functions commonly outsourced include internal audit, payroll, and information systems. Audit rights become an issue because external auditors need to acquire evidence pertaining to financial numbers and internal controls. The auditors may have a difficult time obtaining evidence if a third party "owns" a certain function. External auditors may have a difficult time auditing a third party's systems due to complexity of the systems and the auditors' inexperience with the systems. Third parties will probably not be able to grant the external auditor unrestricted access to the systems and maintain security for the third party's other clients. One way to solve this problem is to allow an independent external auditor to audit the outsourced function. These audits can then be used by internal and external auditors.

Before organizations decide to outsource their internal audit departments, they should objectively review all aspects of the decision. Outsourcing may appear to be beneficial in the short-term, but organizations need to think of their long-term plans. As a company grows and changes, its needs will also change. Once a company has replaced its internal audit department, the department will be very difficult to implement again.

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Reporting

Internal auditors face the challenging job of analyzing situations, making judgements, and reporting results to management. Internal auditors generate reports for the staff, management, board of directors, and audit committee. How do auditors satisfy the needs of all the report users?

If organizations have an audit committee, internal auditors should report directly to the committee. The audit committee should be held accountable for the internal auditors. If an organization does not have an audit committee, internal auditors report to a vice-president of finance or the board of directors. Stockholders prefer internal auditors to report to an audit committee because the audit committee is independent of the actions within the company. If the vice-president of finance manages the internal audit department, he/she may have conflicting roles—improving the company's financial results versus reporting bookkeeping errors and suspicious accounting practices.

What characteristics does an effective audit committee possess? Audit committees consist of three to seven members (preferably with an odd number) who are outside members of the board of directors. The audit committee sets the internal audit charter, reviews internal audit work, selects external auditors, determines what type of audits to perform, examines financial reports, and discusses irregularities and errors. Audit committees, as a whole, should have knowledge in accounting, auditing, and the law.

The director of internal audit should meet with the audit committee at least once a year to update the committee on the department's work and to receive feedback from the committee. All internal audit reports and findings should be submitted to the audit committee. Audit committees should support internal audit's mission by supplying internal audit with needed resources and authority. The audit committee should also set a tone which unmistakably places great pride, respect, and importance on the internal audit function.

Internal audit prepares many different types of reports for different purposes. Since one of internal audit's main purposes is determining whether effective controls exist, reporting on internal control is essential. Congress recently passed a law which requires banks to report on internal controls. This requirement may be enacted for other industries too.
Many companies already include an internal control report in their annual reports. An internal control report should specifically address all relevant controls, the time period examined, material weaknesses in internal control, the audit process, and audit results. The audit committee should be notified of any internal control issues which may cause problems in the future.

Audit reports are negative by nature. This is probably why people dislike auditors. They feel that the auditors just cause problems. These negative feelings can be partially overcome by altering report formats. Audit reports normally focus on negative issues and ignore positive issues. The reports also report as of a certain point in time without taking into consideration improvements since discovery of the issues. By providing minor alterations to audit reports, management will receive the reports with positive attitudes.

Audit reports can be improved by focusing on only major issues. If some of the major issues have been resolved before issuance of the report, the report should state how the issues were resolved. The report should be organized by recording the most important issue first and working down to the least important issue. If a department excels with certain activities, those activities could be mentioned in the report. If some controls are not in place, but they have been effectively substituted for, the report should mention the substitution.

The most effective audit reports focus on solutions, not problems. Managers and board members are more interested in how problems can be solved than in what problems exist. Including management feedback in audit reports also improves effectiveness and goodwill among auditees and auditors. Auditors may want to consider dividing their reports. Reports can be divided according to a summary of the audit, an in-depth analysis of problems, adequacy of outputs, and/or internal control effectiveness.

Audit committees, management, and internal auditors must work closely together to effectively identify and solve problems. Audit committees are responsible for overseeing the internal audit function. Management is responsible for helping the internal auditors complete their jobs and implementing suggestions the internal auditors recommend. Internal auditors are responsible for maintaining objectivity, helping management solve problems, and reporting audit issues to the audit committee.
Article Summaries
Behavioral


Work stress is caused by the nature of the work, the role of the person in the organization, elements in the physical environment, and people working together. The nature of the work is most stressful due to the time pressures auditors are under. Other stressors include giving and receiving performance evaluations and large amounts of travel. Auditors who work for small companies are more likely to experience stress than auditors who work for large companies.


Auditors were asked to discuss the following criteria in reference to job performance evaluations: cooperation with colleagues, concern with costs, cooperation with the boss, effort put forth on the job, concern with controls, and attitude toward work and company. Auditors believe that they are evaluated more heavily on behavioral factors (relationships with colleagues and boss) even though qualitative factors (concern with controls and amount of effort) should carry heavier weights.

Capuder, Sr., Lawrence F. M., "Write to the Top!" Internal Auditor, Oct 94: 54-58.

Writing articles for professional journals is beneficial because it improves writing skills, advances careers, qualifies as continuing professional development credit, earns money, contributes to the profession, assists local professional organization chapters, provides self satisfaction, earns respect from auditees, promotes speaking careers, and sparks invitations to write books. Successful writers draw material from real world experiences, research, and colleagues.


Understanding and developing internal controls should be the objective of internal auditors. In order to achieve that goal, internal auditors need to practice an open door policy, react to verbal and nonverbal messages, react to information without criticizing the auditee, and include auditee knowledge in achieving the goal. Obtaining objectivity should not be done at the expense of being insensitive to the needs of the auditees.


Ineffective interviews are generally caused by biased responses and poor interviewing skills. To conduct an effective interview, the audit area must first be researched. Then, the auditor should decide the objectives of the interview and create an outline covering the interview. Before the interview begins, the auditor should tell the interviewee the interview objectives, how long the interview will last, and who will have access to the interview data. The auditor should ask open and closed questions and evaluate verbal and nonverbal signals during the interview. Verbal
signs that signal fraud include: "inconsistencies in statements, hesitation and incomplete sentences, repeating the question, nervous or false laughter, and voice changes." Nonverbal signals include: increased gestures, averting eyes, increased body shifting, and increased asymmetrical facial expressions.


Before embarking on communication training, management should assess the communication styles of the audit staff. Most auditors assume that some things do not need to be said and some are confused by fast communication. Most auditors prefer narratives and verbal communication. Management should assess which communication style each auditor prefers in order to improve job productivity and enjoyment.


All environments, organizations, and departments constantly change. For this reason, adopting a "back-to-the-basics" approach does not work. What once was successful will not be successful in a different environment. The internal audit function is also changing. "Future auditors must be educators and leaders, promote organizational creativity, facilitate and connect ideas, and develop different skills and mind-sets." A new audit function will still compare what is to what should be, but it will work in a different fashion. Auditors, in the future, may assess strategic implications of systems instead of testing them. Line workers will acquire internal audit skills and test the systems.


Nonverbal behaviors, physical appearance, and the environment affect how people are perceived. Direct eye contact and good posture show competence and credibility. Smiling and moving closer to someone indicates a positive image. Rapid speech signals intelligence and dynamism. Larger people are considered to be more believable. People who sit behind desks are much more difficult to communicate with. Promptness creates a positive image.


What classes are the most important to succeed as an internal auditor? The ability to communicate, written or verbal, is absolutely essential. Other important subject include: auditing, accounting information systems, ethics, electronic spreadsheets, financial accounting, and computer software. These subjects are also the ones in which recent graduates need more education. However, communication was listed as the forerunning weakness. Employers felt that graduates have enough basic accounting knowledge.


In today's society, job security is not guaranteed. Auditors need to learn how to market themselves so that they do not find themselves in the unemployment line. Most job offers are decided
very quickly. Acceptable dress, handshakes, eye contact, and voice control are essential in the interviewing process. How do auditors make themselves more marketable? They develop a portfolio of accomplishments, build professional skills, and begin networking. Also, they always think about tomorrow's position even if they are happily employed today. Job hunting success depends entirely on how prepared the hunter is.


Communication skills are absolutely essential in auditing. However, many new hires do not possess the level of communication that they need. This problem can be avoided by requiring writing samples during the interview process. Then, companies can determine communication abilities before the actual hiring and reduce the cost of training by hiring people who do not need as much training. Also, as this program develops, employers may eventually be able to screen applicants by their responses to the writing sample questions. If students and schools knew that job availability would be based on written communication skills, students and schools would focus on improving written communication skills.


Effective managers are often skillful listeners. Good listeners lean toward the speaker, smile, change facial expressions, gesture naturally, focus their eyes on the speaker, and encourage the speaker to speak. Good listeners also forego judging the speaker, ask relevant questions, and do not interrupt. "You will become interesting to people when you become interested in people."
EDP Auditing

Bodnar, George H., "Data Encryption and Digital Signatures," *Internal Auditing*, Fall 94: 63-68.

Data encryption manipulates electronic data to make it unusable to unauthorized users. As the use of electronic communication grows, data encryption will be used as a common auditing issue. With private key data encryption, one key encodes and decodes messages. The only way to gain unauthorized access to the data is to test every possible key combination. Public key data encryption uses two keys: one public key which everyone knows and one private key which is known only by the individual. The public key encodes messages and the private key decodes them. Digital signatures authenticate electronic signatures. Auditors must assess the costs and benefits of installing an encryption system. Also, auditors must ensure controls exist so that keys are not lost.


Copying illegal software is a serious issue in today's business world. Some users do not realize that when software is purchased, the purchaser is only allowed to place the software on one computer and to make one backup in case the original software needs to be replaced. Purchasers can not rent, lease, or lend software without the permission of the software creator. People who violate the federal copyright act may face civil and criminal damages. Organizations should implement a software management system to ensure that they comply with the copyright act. A software management system includes: appointing a software manager, implementing a software code of ethics, formulating software acquisition policies, developing a storage and security program, registering software, documenting software usage, auditing software usage, and setting home computer usage policies.


Chief Information Officer turnover is extremely high. Information services staff have remained fairly stable the last few years. However, the information services budgets have decreased, indicating a downsizing in services. Many information services use outdated systems. These outdated systems are difficult to replace because replacement costs are so high. Client/server usage has increased dramatically since 1991. Growth in client/server systems was caused by increased budgeting for that purpose. Windows ranked as the most strategic operating system.


Internal auditors spend the majority of their time performing compliance audits. The least amount of time is spent in the systems development life cycle. Small organizations spend more time developing systems than performing EDP audits. However, large organizations have moved the system function out of internal audit. Does independence become a problem when auditors help develop the systems they audit? Most audit directors do not think so; however, most auditors serve as consultants to systems development and not as actual team members. To reduce costs, auditors should be involved in systems development. Auditors can help design
controls and processes into the system that are easy to audit.


Image processing stores documents in the form of pictures and indexes the pictures for easy retrieval. Image processing captures the document image, stores the image, and retrieves it. This system reduces labor costs, processing costs, document loss, and paper usage. The imaging process is vulnerable to fraud if the images are not controlled, errors in the original data, and interruption of the business if disaster recovery systems do not exist. Courts are gradually allowing imaging processing to be used as evidence.


Implementing new systems can greatly improve the overall efficiency and effectiveness of organizations. The traditional audit model will probably evolve into continuous processing—auditing transactions as they occur. Continuous processing is being built into many systems. Systems need to be able to measure data quality so the quality can be improved. When new systems are implemented, the process should be lead by a team of auditors, users, and designers. This team will produce the most effective system. Auditors need to realize that they should train users in the importance of security and control. This will make future audits more effective. Since the IS audit role is changing, management needs to allow their people to think creatively. Auditors will develop unique solutions to problems if they are allowed to push their boundaries.
Environmental Auditing


Most respondents to a survey indicated that their companies are performing environmental audits. The reasons behind the audits included assuring compliance with legal regulations and decreasing risks associated with environmental issues. Most environmental audits are performed by a technical group, not internal auditors since a technical group may be more qualified to conduct the audits. Compliance audits are the most common form of environmental audit performed.


The European Community may require environmental audits in the future. Security Pacific Corporation undertook measures to reduce waste in its company. The internal auditors attempted to eliminate paper based workpapers and to avoid printing computerized reports. These goals were achieved, in part, by using a document management system, using electronic mail, condensing print on reports to print two pages of material on one physical page, and requiring each auditor to find one report that could be eliminated on each audit.


The author believes that internal auditors should be very leery of conducting "energy audits" since most auditors do not have the necessary technical knowledge to perform the audits. Auditors must research the topic for a broad familiarization of energy and controls before beginning an audit, and then proceed with caution.


1. Potential lawsuits can be avoided by scrutinizing current waste management practices in light of future liability.
2. Handle waste with care in all situations to avoid future cleanup liability.
3. Take great care in releasing any hazardous waste. The government may penalize companies that damage natural resources.
4. Consider environmental issues in every company decision.
5. Keep detailed inventory records of waste and submit it to the EPA.
6. Maintain compliance with air and water discharge permits.
7. Sell and buy real estate only after conducting an environmental assessment.
8. Follow federal law regarding wetlands usage.
9. Implement, regulate, and follow OSHA policies.
10. Early and effective environmental compliance can create a competitive advantage.

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The Superfund law gives the waste generator responsibility for the waste forever. If the original generator is insolvent, the responsibility is passed onto the existing owner. Any other parties associated with the waste, such as insurance companies or company executives, may also be held liable. Internal auditors must be knowledgeable of current environmental laws. When acquiring property, environmental issues should be closely considered.


Internal auditors usually deal with valuable scrap. Detailed records should be maintained on the amount and value of scrap. Also, profit from scrap sales should be separately recorded instead of netting them into a purchase or expense account. Every organization should have policies for dealing with scrap.


Corporations are fighting pollution for many reasons: commercial self-interest, company image, to precede regulations, to use knowledge to reduce environmental uncertainty, to identify costs and expenditures, to keep pace with changing societal values, and to follow the government's lead. Internal auditors should audit organization strategies, functional areas, and operational factors in environmental audits.


Insurance companies often avoid financial responsibility by claiming that the company willfully polluted the environment. Courts may not require insurance companies to pay for regulation compliance. Insurance problems can be minimized by keeping a file of all insurance policies, invoices, canceled checks, old shipping records, old production reports, and old accounting records.
Ethics


Whistle blowing is reporting illegal internal acts to external parties. The IIA Code of Ethics does not allow internal auditors to report crimes to external parties without the permission from the organization. In fact, internal auditors must be careful with their audit papers. Auditors could indirectly report to external parties if audit papers contained damaging evidence and the papers were subpoenaed. Conferring with external auditors without management's permission would be a violation of the IIA's Code of Ethics and would be considered whistle blowing. Whistle blowing is absolutely not allowed by the IIA. Internal auditors should resign, not blow the whistle, as a last resort.

"Ethics and Internal Auditors," Internal Auditor, Apr 89: 12-17.

Willard Hick, Marting Weiland, and Herbert Miller were interviewed for this article. None of the organizations presented have an actual code of ethics. Hick believes that ethics can be taught—before six years of age. Weiland believes that ethics are instilled through rules and regulations. Miller prohibits all gifts, but Hick and Weiland believe that gifts and gratuities should be judged more subjectively. Miller believes that ethics cannot be audited, but the results of ethics can be. Hick believes that "ethics can be audited, but it is very subjective."


James Thomas, Inspector General of the U.S. Department of Education, was audited for this article. Thomas believes that internal auditors have a leadership role in establishing and following ethical standards. Thomas believes that adults cannot be taught ethics, however, they can be taught ethical behavior and the importance of ethical behavior. Adults can be taught the difference between right and wrong. Thomas does not think that ethics can be audited; however, the results of ethics can be audited. Thomas believes that everyone has the responsibility for reporting misuse of public funds.


Internal auditors who believe the Code is valuable also believe that it is followed more often than auditors who believe the Code has little value. Also, auditors believe that the Code is not followed as closely as it should be. A company's code of ethics may be more important than the IIA's Code of Ethics to many auditors. Most auditors are more concerned with consequences of their actions than with lower service quality. Auditors who believe that illegal acts should be reported generally adhere more to the IIA's Code of Ethics than auditors who do not believe that illegal acts should be reported.

The most effective way to reduce fraud is to increase the role of the internal auditor. The IIA may push for a required internal audit class in the new five year undergraduate programs. The course would emphasize accuracy, adequacy of rules, economy, efficiency, effectiveness, and accountability—the basics of the comprehensive audit. Internal auditing should require the internal audit director to be a certified internal auditor. The Treadway Commission discovered that the most influential fraud deterrent is the tone set by management. Also, 35 states require CPA candidates to take a professional ethics examination before the candidates can be licensed.


Ethics in the business world are issues that are potential public relation liabilities for the organization, not issues such as downsizing or workplace safety. Businesses seem to be concerned that a commitment to ethics would give the government and special interest groups ammunition to attack the businesses. However, the most successful businesses seem to be the ones with the highest code of ethics. "Determining what is right or ethical is usually not that difficult; however, doing what is ethical can often present a difficult challenge." Why do people act unethically? In most situations, a very ethical person performs an unethical act with what they consider the right motives. Therefore, the ethical act can be rationalized.


"Ethical business practices don't guarantee success; but lack of them certainly results in failure. Management must set the tone for ethical business practices. Ethics involves realizing that a situation may cause harm, who the harm may affect, and deciding what action is appropriate in the situation. People making ethical decisions should ask themselves "Would my family be proud of me if they were aware of my decision?" or "Would I care if my decision were printed in the newspaper?" Internal auditors may turn to the following sources of information for help with ethical decision: the IIA's Code of Ethics, The IIA's Standards for the Professional Practice of Internal Auditing, the IIA position paper on whistle blowing, and consultation with peers.

Tidrick, Donald E., "Ethics and Whistleblowing in the Workplace," Internal Auditing, Winter 92: 3-10.

Should internal auditors blow the whistle? The IIA believes whistle blowing is not necessary "if the organization has an internal audit function that adheres to the Institute's Code of Ethics and its Standards and the internal audit group's director has full access to an active audit committee." If the organization does not respond to the internal auditor's concerns, the internal auditor may want to obtain legal counsel. When internal auditors do whistle blow, they usually tell the external auditors. However, wrongdoing is usually limited to employee theft and mismanagement and waste. The IIA does enforce its Code of Ethics. Auditors can avoid the IIA's Code by not joining the organization and by not using the CIA designation.


Internal auditors often find themselves at odds with the people they work with. Auditors are supposed to help auditees problem solve, and yet at the same time, give negative reports to management. These two roles obviously conflict. The various organizations that monitor internal auditing need to provide clear, specific guidelines in addressing ethical issues.
Fraud


Fraud occurs because of a combination of the following factors: a "nonsharable" pressure, a perceived opportunity, and some way to rationalize the behavior as acceptable. Most cases of fraud are committed by first-time offenders who compromised existing internal controls. Most existing fraud programs follow these steps: fraud suspicion, investigation, determination of action to take, and wrapping up the situation. However, organizations would benefit more from fraud prevention. A fraud prevention program would follow these steps: prevention programs, fraud occurrence, fraud reporting, investigation, criminal prosecution, incident follow-up, analysis of the situation, publish cases in an internal publication, implement new controls, test the controls for compliance and training, and proactive fraud auditing. "Management must emphasize fraud prevention and adopt a more proactive approach to fraud, rather than continue to react after the losses occur."


The audit techniques examined pertained to the sales and collection cycle. More internal auditors than external auditors had detected fraud. Audit techniques that were determined to be "more effective" were: "verification of separation of duties, collection of evidence from independent sources outside of the client organization, investigation of differences between externally collected evidence and customer transactional information recorded in ledger accounts, verification of journalizing and posting procedures with regards to credit granted and customer payments, and verification of the matching process of documents." The previous procedures should be performed early in the audit process to increase chances of detecting fraud. Audit procedures determined to be of "average effectiveness" "involved examination and tracing among internal controls, source documents, cash receipts journals, and accounts receivable." Audit procedures determined to be "less effective" include "discussions, inquiries, comparisons, and auditor computations." Related party transactions, usually a red flag in fraud discovery, were only deemed to be of average effectiveness. Analytical procedures were determined to be less effective even though they are required to be performed during all three audit phases.


The Statement on Internal Auditing Standards No. 3 "requires that internal auditors be alert to control weaknesses that could allow fraud, evaluate the indicators that fraud may have occurred, and notify appropriate authorities within the organization. In order to successfully fight fraud, internal auditors need to clearly understand their role in fighting fraud, and auditees need to understand the policy for detecting and reporting illegal acts. If an organization does not have a fraud program, recent history should be used as a starting point. SAS No. 53 suggests that auditors look for suspicious situations where one person dominates decisions, auditees have been empowered and are not monitored closely, and many difficult accounting issues are found. SAS No. 3 suggests that a report be prepared to summarize fraud detection. However, for the report
to be effective, management must have approved reporting procedures before a report is issued.


The IIA's Code of Ethics states "Members and CIAs shall exhibit loyalty in all matters pertaining to the affairs of their organization or whomever they may be rendering service." Internal auditors report to management, not the public. Since internal auditors are responsible to the organization, how do they have help ensure the public that external financial statements are free of fraud? The most effective solution would be to place the chief internal auditor on the audit committee. Then, internal auditors would have more responsibility in reducing fraud. Other solutions include allowing internal auditors to discuss information with external auditors and protecting internal auditors from losing their jobs when they report fraud.


Fraud hotlines help deter fraud. They are usually operated by either the internal audit department or by the security department. The department that first requested the hotline is usually the one that operates it. Hotlines can be effective even if monetary rewards are not offered to callers. Fraud hotlines are advantageous because they encourage communication from employees, strengthen internal controls, are cost effective, detect external and internal fraud, build public relations, and help deter fraud. However, fraud hotlines do receive "prank" calls. Allowing anonymous callers (which is highly recommended for success) may result in obtaining insufficient information.


In order for an organization to successfully fight fraud, top management must support the fight. The best time to enlist management's support is immediately after a fraud case has been mishandled and before another one has occurred. Internal auditors can detect fraud by using the following five steps:

1. Know fraud exposures in specific terms.
2. Know exposure specific symptoms of fraud.
3. Be alert for fraud symptoms.
4. Incorporate into routine audits program steps that are likely to reveal fraud symptoms.
5. Follow through on all observed symptoms.

Internal audits can successfully detect and investigate fraud, but fraud cannot be prevented without management support.


Organizations must be able to "identify suspected wrongdoing early, conduct complete and thorough investigations, take appropriate action based upon investigation results, and correct identified control weaknesses" in order to fight fraud. Internal auditors must have the knowledge needed to identify, investigate, and prevent fraud since they have a reasonable responsibility for detecting it. In order to have a successful fraud policy, an organization must have a strong code
of ethics and strong management support.


Fraud Assessment Questioning (FAQ) relies on the belief that people do not naturally lie. Therefore, by asking structured, nonaccusatory questions, auditors can discover fraud. FAQ begins by asking general questions and then working into specific questions. Interviewees who know of fraud or who have perpetrated fraud will give oral and nonoral signals when answering questions. Used correctly and by experienced interviewers, FAQ can help auditors fight fraud.
Operational Auditing


Re-engineering is the redesign of business processes to achieve improvements in cost, quality, service, and speed. Five prototypes give ideas on how to improve current processes: combine several jobs into one, reorganize steps into a natural order, perform work where it makes the most sense, hybrid operations, and use controls in every production activity. Internal auditors should be able to recognize a solution and then understand which problem the solution will solve in order to be pro-active business people. Activities should be re-engineered from the customer's point of view (what they want), not from what the company hopes to achieve. Auditors should "focus on processes rather than departments, tasks, or functions" in order for solutions to be optimal for the entire organization and not just a certain department or function.


Should operational auditors be experts at auditing and/or in all operating areas that are audited? The study in this article indicated that there is a "very strong preference for an accounting education background for operational auditors." In fact, the two factors that provide the most familiarity with the environment were seen as the least important in this study.


The audit process is broken into eight logical steps by the audit approach call the CAA (commonsense audit approach).
1. Determination of audit objectives.
2. Knowledge gathering, general overview, and risk assessment.
3. Defining the audit plan and schedule.
4. Understanding and documenting actual, existing controls and conditions.
5. Test specific controls in place
6. Identify missing controls and conditions that do not exist or are not in place.
7. Evaluation of non-operating specific controls and missing controls (cost/benefit).
8. Report to management.


"Allstate's seven-step plan explains how internal auditors identify potential operational audit topics, define key assertions, assess business risks, and decide whether to continue the audit." This plan makes the selection process more effective and helps auditors to be more productive.
1. Recognize operational audit opportunities.
2. Specify the operational audit topic.
3. Define the assertions to be tested.
4. Assess the business consequences should the assertion prove false.
5. Assess the likelihood that the assertion may be false.
6. Decide whether the assertion can be audited effectively and efficiently.
7. Prioritize the audit topic relative to other topics.


Auditing with a cultural approach requires "attention to both specific practices and underlying systems." Financial audits assess deficiencies in processes while cultural audits examine why things occur and how those things can be improved. Deficiencies are seen as clues to a larger problem in cultural auditing but are seen as the end result in financial auditing. Key audit techniques used in a cultural approach include: participant observation, key informant interviewing, informal and structured interviews, expressive autobiographical interviews, triangulation, physical traces, archives, folktales, and questionnaires.


The Standard Audit Process takes auditors through the same steps audit after audit. All audits are not the same; therefore, the audit steps should probably be altered for each audit. Perhaps the product of the audit should be standardized, not the audit process. The audit should focus on customer needs, customer requests, what product to deliver, and how the product is presented.


"DEA (data envelopment analysis) is a linear programming-based technique that converts multiple input and output measures into a single comprehensive measure of relative efficiency." With DEA, departments or functions can be measured against each other instead of being measured against average performance. The departments or functions can then also be evaluated individually. DEA inefficiencies only indicate potential problems, they do not pinpoint problems. DEA should be used in conjunction with other measures of efficiency. DEA does not measure effectiveness.


The socio-technical systems analysis requires auditors to look at processes and how people apply technology. This audit process focuses on the people who actually do the work. The audit process is as follows:

1. The scan--basic objectives, environmental analysis, organizational analysis, product analysis, definition of critical roles
2. The technical system analysis--grouping essential tasks, identify process variances, identify key variances, and constructing a Key Variance Control Table.
3. The social system analysis--identify key focal roles in the process, control the role network for each key focal role, and match key variances with basic social system functions.
4. Recommendations--design a social structure that anticipates problems and quickly corrects actual problems.
Outsourcing


External auditors may not rush to perform internal auditing because their liability may increase if they give a company a clean opinion on internal controls. External auditors may not be less expensive than internal auditors because the external auditors would probably require a more intensive review to keep their litigation liability down. External auditing firms may not have the technical expertise to perform internal audits. The focus of internal audits is on operational items, not financial statements; therefore, external auditors may have a difficult time converting the audit focus. Also, external auditing firms may not want to perform internal audits because they have a bias against internal auditing--internal auditing is not respected by all external auditing firms.


External auditing firms use the following justifications for bidding for internal audits: a more qualified staff, better planning, a greater emphasis on internal control, discount pricing and lower overall cost, and continuity of internal audit operations. However, these justifications are not necessarily true. For instance, internal auditors have access to the expertise of their external auditors and other internal auditors. Internal auditors have, without a doubt, the most expertise of their organization's control strengths and weaknesses. When external auditors offer to perform internal audits at a reduced rate, organizations need to watch for an increase in costs elsewhere. External auditors claim to maintain continuity of operations by hiring a few internal auditors from the organization, but is this actually continuity of operations?


Information systems are outsourced to service centers in order to reduce costs, improve service, and focus on core business. When this service is outsourced, internal auditors have a difficult time obtaining audit rights. Who will audit the information systems? The organization no longer has control over the system, and allowing auditors to examine the service center's system would be a breach of security. Also, the service center will not be eager to teach the auditors about the complexity of the system. The solution may be to have a third party audit the service center. However, this audit may not meet the detailed need of the internal auditors.

James, Marianne L., "Outsourcing from the Public Accountants' Perspective," Internal Auditing, Summer 94: 55-58.

When organizations outsource their internal audit function to their external auditors, the auditors may face independence problems. If the Wyden Bill passes, external auditors would be required to report client fraud. This would significantly affect the number of organizations wanting to outsource the internal audit function. Other questions affecting outsourcing include: Should the same staff be used in internal and external audits?, Should results from one audit (internal) be used to support results from another audit (external)? and Should the auditee have control over
the audit?

Morris, Norman, "Is Internal Audit Being Run by Public Accounting Firms?," *Internal Auditor*, Feb 81: 53-55.

Before becoming internal auditors, most internal auditors have worked for a public accounting firm. The guidelines used for internal auditing are the "accounting principles established by the American Institute of Certified Public Accountants." Internal auditing may be moving from an operational focus toward a financial statement focus. If this is the case, then internal auditing is definitely being influenced by external auditors.


If external auditors completely manage the internal audit function, an independence and/or conflict-of-interest problem arises. Do external auditors provide experienced staff for internal auditing? Probably not since their staff is trained as external, not internal, auditors, and external auditors usually have a high percentage of new people on each audit. If external auditors perform the internal audit function, then the organization looses a valuable supply of experienced accountants.
Reporting


Independence is essential as an internal auditor. The audit committee chairman and internal auditors must have confidence in each other and they must have confidentiality in their dealings in order to promote internal controls. Internal auditing should not be a temporary job; it should be a career path. The audit committee should stand unquestionably behind the internal auditors, and should push for a stronger internal audit function. Internal auditors are the best defense against fraud and wrongdoing in the organization.


Audit committees would be effective monitors of government agency activities. The audit committee needs to set an appropriate ethical tone immediately. This is the most effective way to deter illegal acts and fraud. Internal auditors can serve the audit committee by being given organizational status, being independent of management, developing a working relationship with the audit committee, and including the audit committee in many of the internal audit activities. Members of the audit committee should possess "a general management background with some skills at interpreting financial information," and at least one member should have some auditing background. Professors, nonpracticing CPAs, engineers, actuaries, bankers, lawyers, and retired executives are excellent choices for audit committee membership.


Audit reports should "assure management that internal control procedures have been established and are followed and report control weaknesses for the purpose of correction." The report should not create negative feelings between the auditors and auditees. When writing an audit report, keep the overall purpose of the audit report in mind, try to capture the audit meeting environment, emphasize what is important, and write clearly. Audit reports should stress which things are done well and which things are serious problems, and they should never leave the reader wondering what the actual message is.


Internal auditors are commonly viewed as "policemen" when they should be viewed as partners in problem solving. In solution-focused audit reporting, the auditees view internal auditors as partners. Auditors report on what they find, try to find relationships between problems, and suggest solutions to problems. This system can be enhanced when the audit report includes solutions the auditees have already put into action. Also, the report can be tailor-made for all audiences. PepsiCo divided its report into an executive summary and a more detailed discussion to satisfy senior and line management.

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The most effective audit committees have three, five, or seven members. Fraud occurs more frequently when an audit committee exists if the audit committee is not authorized enough resources, the CPA was not completely independent (also performed management advisory services), management obtains a second auditor's opinion, or the internal auditor is not independent. Audit committee members should be outside independent directors of the board. The audit committee should examine financial statement variations, items that materially affect statements, reporting issues, items in dispute with the IRS, and the status of related tax reserves.

This article was based on the Statements on Internal Auditing Standards No. 7. The director of internal auditing should report regularly to the audit committee and should be responsible for reviewing the internal auditing charter. The director of internal auditing should also notify the audit committee of any audit limitations and the effect of the limitations. The internal auditing department must report the results of their work in writing to the audit committee along with findings that could adversely affect the organization and the status of such findings. The audit committee should also be aware of "significant deficiencies in the design or operation of the internal control structure."

Internal auditors are not required to report fraud to external parties even if the audit committee decides not to take action. An internal channel of communication and weak retaliation are factors which result in a greater likelihood of whistle blowing. Internal auditors are more likely to report fraud internally than externally, although disclosure is highly unlikely under any circumstance. The fear of losing their jobs is the single most effective deterrent to internal auditors for not to blowing the whistle.

Audit reports should state the "purpose, scope, audit results, and auditor's opinion." Every organization needs to have clear guidelines for audit reporting to maintain consistency in the internal audit function and respect for the internal auditors. The most effective report may have two opinions--"one on the system's performance or outputs and one on the adequacy of the internal controls." Then, each opinion can have its own criteria.

Audit committee members usually show an interest in accounting or auditing. The best amount of members is between three and seven. The internal audit function should be independent. The best way to achieve independence is to report directly to the board of directors or to the audit
committee. The internal auditing department charter should be reviewed every three to five years. The director of internal audit should meet with the external auditor and each should have access to the other's working papers.


The average internal audit department has 24 professional members, although size relates to how many assets the company owns. Larger internal audit departments meet with the audit committee more often than smaller departments. Most internal audit departments focus their efforts on evaluating the overall controls in the organization. The internal audit director usually presents reports orally to the audit committee. One third of the audit committees polled wanted the internal audit departments to extend the scope of audits and/or add a completely new audit. Audit committees and internal auditors usually communicate about coordinating activities with the external auditor.


A new law passed in Congress requires bank management to report on the internal control system. External auditors also have to provide an attest engagement on the internal control system. Although this law only pertains to banks with over $150 million of assets, Congress has indicated that it might extend the law to pertain to all publicly held companies.


Many publicly held companies already include internal control issues in their annual reports. Internal auditors should issue reports to the audit committee that include information pertaining to internal controls, the time frame of the report, knowledge of any material weaknesses, the internal auditing process, and scope and findings. The internal audit department should notify the audit committee of what they plan to do, how they plan do it, what they hope to find, what they actually found, and what actions should be taken.