Internal Audit Best Practices & Fundamental Principles

Danny M. Goldberg
CPA, CIA, CISA, CRISC, CRMA, CGEIT, CCSA

Based on the practice series *BNA Tax and Accounting Portfolio, Internal Auditing: Fundamental Principles* (Accounting Policy and Practice Series), which is authored by renowned audit scholars Curtis C. Verschoor and Mort A. Dittenhofer – co-author of Sawyer’s Internal Auditing (Mr. Goldberg is accredited as professional commentator).
Danny M. Goldberg, Partner - Professional Development

Danny M. Goldberg leads the Professional Development Practice at Sunera. Prior to joining Sunera in January 2011, Danny founded SOFT GRC, an advisory services and professional development firm. Danny has over 15 years of audit experience, including five as a CAE/Audit Director at two diverse companies. He has the rare experience of leading the establishment of three internal audit/SOX departments.

Prior to founding SOFT GRC, Danny was the Director of SOX Compliance and Corporate Audit at Dr Pepper Snapple Group, where he led the Year One SOX Compliance efforts. Prior to his tenure at Dr Pepper, Danny was the Chief Audit Executive at Tyler Technologies, a publicly traded technology company (Danny was hired to build the department from the ground up).

Prior to his experience at Tyler, Danny was also part of the Year One SOX Compliance team at Tenet Healthcare, where he assisted the end-to-end compliance efforts. Danny began his career at Arthur Andersen and is a graduate (BS – Accounting, 1997, MS – Finance, 1998) of Texas A&M University.

Danny has served on the audit committee of the Dallas Independent School District and he currently serves as the Chairman of the North Texas Leadership Council of the American Lung Association and is the IIA Dallas Chapter Programs Committee Co-Chairman for the 2011-2012 year.

Danny is accredited as the professional commentator on the publication *BNA Tax and Accounting Portfolio, Internal Auditing: Fundamental Principles* (Accounting Policy and Practice Series), which is authored by renowned audit scholars Curtis C. Verschoor and Mort A. Dittenhofer – co-author of *Sawyer’s Internal Auditing*.

He has also published numerous articles in trade magazines, including:

- ISACA Journal (The Missing Piece: Optimized Interpersonal Skills, May 2012)
- The Audit Report (Executive Search: Knowing the Company is as Important as Knowing the Candidate, December 2011)
- ISACA Journal (General Auditing for the IT Auditor: An Overview, May 2011)
- The Audit Report (11 Hot Topics for 2011, March 2011)
- Dallas Business Journal (The Yes Man Phenomenon, January 2011)

Danny is a well-known speaker across the nation at numerous IIA and ISACA sponsored events. Mr. Goldberg has been recognized as a top speaker at numerous events over the past 6 months, including:

- “Top Rated” (Excellent/Outstanding) Speaker – 20th Annual American Society for Quality (ASQ) Audit Division Conference (out of 44 presenters)
- Top 10 Presentation – 2011 IIA Midwest Regional (36 total concurrent sessions, 3.75 overall rating out of 4.0)
- Top 3 Ranked Speaker – Michigan CPA’s Healthcare Conference 2011 (29 total speakers)
- Top 3 Ranked Speaker – ArkSarBen IIA 2011 District Conference (24 total sessions)
- 3.58/4.00 Rating – 2011 ACFE Annual North American Conference

Danny is one of less than 100 speakers worldwide invited to present at the 2012 IIA International Conference.

Danny is a Certified Public Accountant, Certified Internal Auditor, Certified Information Systems Auditor, Certified in the Governance of Enterprise Information Technology, Certified in Risk and Information Systems Control and has obtained his Certification in Control Self-Assessment.
Internal Audit Best Practice and Fundamental Principles

A Two Day Crash Course on the best practices internal audit has to offer.

Seminar Overview
Based on Danny M. Goldberg's professional commentary on the Bureau of National Affairs Practice Series Internal Audit Best Practices and Fundamental Practices (authored by legendary audit scholars Curtis C. Verschoor and Mort A. Dittenhofer – co-author of Sawyer's Internal Auditing), this two-day seminar will take you through emerging trends and techniques in the internal audit world. Attendees should learn about real-world training and concepts they can apply in their department immediately.

Prerequisite: None

Advance Preparation: None
Learning Level: Basic/Intermediate
Field: Auditing
Delivery Method: Group-Live

Who Should Attend
Financial, Operational, and Information Technology Auditors with any amount of experience.

Agenda

I. Introduction and Background
   a. Background
   b. Topics to Cover

II. Audit Risk Assessment
    a. IIA Standards
    b. Long Range vs. Short Range Planning
    c. What is an Audit Risk Assessment?
    d. Heat Maps
    e. How does the ARA integrate with the ERM?
    f. Comprehensive Example
    g. Understanding the business

III. Fieldwork Best Practices
    a. Managing the audit engagement
    b. Audit Testing

IV. Audit Report Writing
    a. Auditor Guidance
    b. Audit Report Structure
       i. Executive Summary
       ii. Observations
       iii. Appendices
    c. Executive Summary Components
       i. Audit Summary
       ii. Audit Objectives
       iii. Audit Scope
       iv. Background
v. Opinion
vi. Overall Report Ratings
vii. Standards Conformance Statement
d. Observation Components
   i. Foundation
   ii. Condition
   iii. Cause
   iv. Effect
   v. Recommendations
   vi. Action plans
e. Other Sections of Audit Observations
   i. Additional information
   ii. Exhibits
   iii. Policies and procedures
   iv. Observation Formats
f. Report Optimization
   i. Standard 2420
   ii. CCCC PV
V. Audit Follow Up
   a. Audit Standards
   b. Audit Follow Up Policy
   c. Action Plan Maturity Model
   d. Timing/Method of Follow Up
VI. Optimization Audit Best Practices
   a. The OA Process
   b. Optimization Assessment
   c. Documenting Understanding
   d. Segregation of Duties
   e. Assessing Efficiency/Effectiveness and Cost/Benefit
VII. Control Best Practices
   a. COSO
   b. What are Internal Controls?
   c. 5 Key Internal Control Activities
   d. Testing Controls
VIII. Integrated Auditing
   a. Audit Process Similarities
IX. Fraud Red Flags
   a. Fraud Overview
   b. Financial Reporting/Close
   c. Cash
   d. Revenue/Accounts Receivable
   e. Inventory
   f. Purchasing/Cash Disbursements
   g. Payroll
   h. Fraud Red Flags
X. Optimized Communications
   a. Overview
   b. 7 C’s to Effective Communication
   c. General Communication Issues
   d. Confrontation
   e. Listening Techniques
XI. Interviewing
   a. Interview Management
   b. Managing Yourself
   c. Personalities
XII. Practical Ethics
   a. What is Ethics?
   b. Key Influences on Ethical Behavior
   c. Complex Ethical Decisions
   d. Famous Ethical Decisions
   e. 4 Methods to Resolve Ethical Dilemmas
Internal Audit Best Practices and Fundamental Principles

Danny M. Goldberg
CPA, CIA, CISA, CRISC, CRMA, CGEIT, CCSA
Partner, Professional Development

Introduction
Danny M. Goldberg

- Partner, Professional Development (www.sunera.com)
- Founding Partner, SOFT GRC (www.thesoftaudit.com)
  - Sold to Sunera January 2011
- Former Director of Corporate Audit/ SOX at Dr Pepper Snapple Group & Tyler Technologies
- Published Author (Book/Articles)
- Texas A&M University – 97/98
- Father of two beautiful kids!

Danny M. Goldberg (cont.)

- CPA – Since 2000
- CIA – Since 2008
- CISA – Since 2008
- CGEIT (Certification in the Governance of Enterprise IT) – Since 2009
- CRISC (Certification in Risk and Information Systems Control) – Since 2011
- CRMA (Certification in Risk Management Assurance) – Since 2011
- CCSA (Certification in Control Self-Assessment) – Since 2007
- Chairman of the Leadership Council of the American Lung Association - North Texas
- Served on the Audit Committee of the Dallas Independent School District (CY 2008)
- Current Dallas IIA Programs Co-Chair (2011-2012)
- Former IIA Volunteer Instructor
- Published Author
  - November 2010 – Bureau of National Affairs - Internal Audit: Fundamental Principles and Best Practices
  - Internal Auditor Articles (August 2007, December 2007, October 2010)
  - ISACA Online Article – December 2009
  - Audit Report Articles (June 2010 Cover, March 2011, March 2012)
  - December 2010 New Perspectives - Sell Your Work: How to Deliver Best Practice Audit Reports
Danny M. Goldberg – Speaker Bio

- Speaking publicly for 5 years
- Relationships with over 55 IIA/ISACA Chapters throughout the WORLD.
- Work with multiple Fortune 1000 Internal Audit Departments
- Work with numerous other professional organizations throughout North America, including:
  - State Auditors Office of Numerous States
  - North Texas Independent School District Peer Group
  - National Lottery Association
  - North Texas Oil and Gas Peer Group
  - ASQ Audit Division
  - Texas Society of CPA’s
  - Bank Internal Auditors Association of Western Pennsylvania
- References from all IIA/ISACA Chapters worked with
- “Top Rated” (Excellent/Outstanding) Speaker – 20th Annual American Society for Quality (ASQ) Audit Division Conference (out of 44 presenters)
- Top 10 Presentation – 2011 IIA Midwest Regional (36 total concurrent sessions, 3.75 overall rating out of 4.0)
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- 1 of 100 Presenters invited to present at the 2012 IIA International Conference

Sample Professional Development Association Clients

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Sunera Snapshot

- **Professional consultancy** focused on regulatory compliance, internal audit, information technology & accounting advisory services
- Founded by former public accounting partners and professionals
- Delivered more than **1500 projects** to over **300 clients** across a broad spectrum of industries
- Employ **full-time professionals** in **twelve offices** across the United States and Canada
- **PCI Qualified Security Assessor (QSA)** & Approved Scanning Vendor (ASV)
- Registered with NASBA to offer CPE’s for our ACL & Internal Audit training courses
- **Certified integration partner** for leading continuous controls monitoring solutions, including **ACL, Approva & SAP**

Sunera Offices

- Offices in Miami, Tampa, Orlando, Atlanta, Dallas, Toronto, Vancouver, Calgary, Boston, New York, Phoenix, Houston, Raleigh, Orlando, and Miami.
Why Sunera?

- **The Right Experience** – Our team’s experience in providing Corporate Governance, Risk Management, Regulatory Compliance, Professional Development and Recruiting/Staffing solutions is unparalleled in the marketplace. Our methodologies are solid as well as flexible to meet our clients’ needs. Our extensive services menu is enhanced by our position as a leading information security services provider. In addition, we are one of a select group of companies that are certified by the Payment Card Industry (PCI) to conduct formal assessments, trusted advisory engagements, and on-site audits.

- **The Right People** – Our team has built Internal Audit functions from the ground up, led multi-national SOX projects, and conducted Enterprise/Technology Risk Management services for companies ranging from the Fortune 50 to start-up organizations. Our people are the lifeblood of our firm and are among the most credentialed professionals you’ll find anywhere. Most are former “Big Four” employees and, in the Dallas Office alone, have the following certifications: CPA, CIA, CISA, CFE, CCISA, CFSA, CIDA and CISSP. However, more than just “letters behind names”, we become integrated team members with our clients, and know how to work with your team to achieve your objectives.

- **The Right Footprint** – Sunera is the fastest growing non-attest independent consulting firm in America. We have increased our workforce 70% in 2011 through organic growth and strategic acquisitions. With 13 offices in the U.S. and Canada, we can be where you need us when you need us.

- **The Right Cost of Investment** – Sunera offers value-driven rates and fees that are often significantly less than our competitors for the caliber of our professionals.

Contact Information

Please contact any of the following Sunera Texas Leadership Team members:

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<th>Phone Number</th>
<th>Email</th>
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<tbody>
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**Houston Office Address**
5100 Westheimer Road
Suite 200
Houston, Texas 77056
Unit II: Audit Risk Assessment/Planning

IIA Guidance on Planning and Scheduling of Engagements

- CAE has a responsibility to assure the audit committee that the outcomes of planned internal audits will result in maximum value to the organization in relation to their cost.

IIA Professional Standard 2010 requires:
- The CAE should establish risk-based plans to determine the priorities of the internal audit activity, consistent with the organization’s goals.
- Plan should be:
  - detailed enough to enable the internal audit activity to achieve the objectives of internal auditing that are set forth in its mission statement and charter document.
  - The plan should also be based on an assessment of risks throughout the organization.
IIA Guidance on Planning and Scheduling of Engagements (cont.)

- Practice Advisory 2010-1, *Planning* explains in paragraph 1 the process as establishing: goals, engagement work schedules, staffing plans and financial budgets, and activity reports.

- Coordinate internal audit activity objectives with those of the external auditor. IIA Professional Internal Auditing Standard 2050, *Coordination* provides guidance:
  - The CAE should share information and coordinate activities with other internal and external providers of relevant assurance and consulting services to ensure proper coverage and minimize duplication of efforts.

IIA Guidance on Planning and Scheduling of Engagements (cont.)

- Practice Advisory 2050-1 *Coordination* notes that the audit committee may ask the CAE to aid in the committee’s oversight by requesting an evaluation of the performance of the organization’s external auditors.
  - Required by NYSE listing rules.

- The Practice Advisory (2050-1) in paragraph 6 provides guidance that such assessments should be made only at the specific request of senior management or the audit committee.
Long Range Planning

- Long range planning schedules should be established, usually for a five-year period on a rolling basis.
- The long range schedule should be analyzed for auditability, coverage of business risks, performance standards and controls, resources, and time elements.
- Basic objectives should be set considering the objectives and goals set forth in the definition of internal auditing: “to evaluate and improve the effectiveness of risk management, control, and governance processes.”
- Risk management - “identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and control systems.”
- Control - “evaluating the adequacy and effectiveness of controls encompassing the organization’s governance, operations, and information systems.”

Long Range Planning

- Long-range schedule should act as a guide for establishing the short range schedules.
- Essentially objective-oriented and is integrated with the goals and objectives of internal auditing.
- While there is no precise structure for preparing a long-range audit schedule, elements to be considered are:
  - objective of the audit,
  - required estimated resources (including time of audit staff, travel, and specialized staff needs, if any),
  - risk priority,
  - management areas of interest,
  - relationship to the external audit or other internal audits,
  - special audit emphasis, and
  - external requirements (contractor, Government, Regulations).
Short Range Planning

- Based on the long range schedules, the CAE establishes short-range schedules that include many of the same elements.
- Usually for one year.
- They are reported to management and the audit committee on a quarterly basis (AT LEAST).
- The report will show progress relative to the planned program and the estimated time of completion.
What is an Audit Risk Assessment?

- Identification and analysis of relevant risks to the achievement of an organization’s objectives, for the purpose of determining how those risks should be managed.
- Initial determination of operating objectives, then a systematic identification of those things that could prevent each objective from being attained. In other words, it’s an analysis of what could go wrong.
- Not all risks are equal.
- Some are more likely than others to occur, and some will have a greater impact than others if they occur.
  - probability and significance must be assessed.
- The risk assessment process is an ongoing one.

![Sample Heat Map](image-url)
Audit Risk Assessment - Overview

- Define the audit universe and identify the auditable units within the entity for which these analyses will be carried out.
- Identify appropriate risk factors designed to reflect management’s concerns.
- Evaluating risk factors (e.g. heat map) so that the more important risk factors play a more prominent role in the risk assessment process than less important risk factors.
- Develop a combination rule for each audit unit which will properly reflect its riskiness over several risk factors that have been identified and a method of setting audit priorities for the audit units.
- Once audit units have been rated according to their riskiness, it is important to have a mechanism for assigning them to audit frequency categories and a mechanism for applying variable audit scope or intensity of auditing commensurate with the importance of the audit unit.

Discussion – How Often Should the ARA be Refreshed?
Comprehensive Example

- Please see the following slide
- Outline which audits should take priority
- Address open questions
- Discuss which audits are the most important

Questions to Answer

- What would cause the probability/significant factor on the operational audits?
- Why would probability of substantive work be 100%?
<table>
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<tr>
<th>Audit Type</th>
<th>Audit Description</th>
<th>Estimated Total Hours</th>
<th>Probability Factor</th>
<th>Significance Factor</th>
<th>Value of Area</th>
<th>ARA Categorization</th>
<th>Color Coding</th>
<th>Scheduled Start Date</th>
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<td>SOX</td>
<td>Corporate Key Processes</td>
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<td>100</td>
<td>100</td>
<td>N/A</td>
<td>10,000</td>
<td>Red</td>
<td>7/15/2011</td>
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<td>240</td>
<td>100</td>
<td>100</td>
<td>N/A</td>
<td>10,000</td>
<td>Red</td>
<td>8/11/2011</td>
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<td>Operational</td>
<td>Division B Payroll</td>
<td>450</td>
<td>71</td>
<td>48</td>
<td>Revenue – 100M</td>
<td>Red</td>
<td>Red</td>
<td>4/10/2011</td>
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<tr>
<td>Operational</td>
<td>Procurement (corp-wide)</td>
<td>225</td>
<td>50</td>
<td>17</td>
<td>Process 150M Annually</td>
<td>Yellow</td>
<td>Yellow</td>
<td>3/15/2011</td>
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<tr>
<td>Substantive</td>
<td>External Audit Assistance</td>
<td>150</td>
<td>100</td>
<td>10</td>
<td>$250/hour external</td>
<td>Red</td>
<td>Red</td>
<td>6/30/2011</td>
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<table>
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<th>Key</th>
<th>Probability Factor</th>
<th>Color Coding</th>
<th>Key</th>
<th>Significance Factor</th>
<th>Critical Risk</th>
<th>Medium Risk</th>
<th>Low Risk</th>
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<td>1-100 (100 is likely to occur in the period under review)</td>
<td>Low Risk</td>
<td>Medium Risk</td>
<td>High Risk</td>
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<tr>
<td></td>
<td>1-100 (100 is likely to occur in the period under review)</td>
<td>Medium Risk</td>
<td>High Risk</td>
<td></td>
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One of the greatest values that internal auditors have is their understanding of the organizations they audit.

- Risks and exposures
- Internal controls
- Processes and procedures
- Interrelationships (departments and people)

Understanding the Business

- Taking the time to observe and learn
- Reading, reading and more reading
- Participating in organization events
- Building business relationships
- Participating in outside organizations
Managing Yourself – Risk Analysis

**Major Types of Risk**
- Strategic
- Financial
- Operational
- Compliance
- Reputational

Diagram:
- Governance → Goals → Objectives → Strategy → Procedures → Steps
Unit III: Fieldwork
Best Practices

What are:
• Issues you had with fieldwork?
• Documentation issues
• Audit Evidence?
• Etc?
MANAGING THE AUDIT ENGAGEMENT

Completing the engagement successfully, on time and within budget

Managing Engagements – Management Functions

- Planning
- Organizing
- Leading/Directing
- Monitoring
- Motivating
Audit Engagement - Planning

- Objectives (Risk-based)*
- Scope (Sufficient)*
- Resource Allocation (Appropriate)*
- Work Program (Relevant)*
- Completion Dates (Reasonable)


Audit Engagement - Planning

**Objectives – SMART**
- Specific
- Measurable
- Achievable
- Results-Orientated
- Time-Based
Audit Engagement - Planning

**Scope Challenges**
- Too Broad
- Too Narrow
- Not Adequately Defined
- Creeping
- Inappropriate

**Scope Challenge Solutions**
- Knowledge is King
- Effective Preliminary Survey
- Customer Involvement
- Prior Audit History
Audit Engagement - Planning

<table>
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<tr>
<th>Engagement Program - Goals</th>
<th>Engagement Program - Challenges</th>
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<tr>
<td>Supportive of Audit Objectives</td>
<td>Irrelevant or inappropriate steps</td>
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<tr>
<td>Complete</td>
<td>Missing steps</td>
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<tr>
<td>Logical</td>
<td>Unorganized or disorganized</td>
</tr>
<tr>
<td>Reasonable</td>
<td>Untested or excessive program preparation time</td>
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<tr>
<td>Approved</td>
<td>Implemented without adequate audit oversight</td>
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Audit Engagement - Planning

**Completion Dates**

- Achievable – Are they realistic?
- Reasonable – Do they consider the unexpected?
- Flexible – Are they adjusted for unplanned events?
- Agreeable – Is there consensus that they can be met?
Audit Engagement - Planning

Impact of Poorly Determined Completion Dates
- Missed Deadlines
- Unhappy Customers
- Lowered Staff Morale
- Misallocation of audit resources
- Additional Costs

Audit Engagement – Leading/Directing
- Timely
- Significant
- Appropriate
- Constructive
- Documented
Audit Engagement - Monitoring

- Benchmarks/Milestones
- Change Approval Process
- Progress Reports
- Timely Workpaper Reviews
- Update Meetings

Multiple Project Management Pitfalls

- Scope Creep
- Time Constraints
- Unforeseen Problems
- Inadequate or Ineffective Staffing
- Missed Deadlines
Multiple Projects - Essentials

- Prioritization
- Communication
- Timely Reporting
- Delegation
- Know When to Say No

Testing

- The procedure of testing is a methodology that is a major part of the previously described process of verifying. It is simply the determination of:
  - Validity
  - Accuracy
  - Compliance
  - Competence of controls
Audit Evidence

Audit evidence is an integral part of every internal auditing engagement. There are six types of internal auditing evidence.

- **Physical Evidence** – observing people, property, and events
- **Testimonial Evidence** – letters or statements with support or documentation
- **Documentary Evidence** – External letters, papers, documents, invoices, contracts, confirmations from outside sources: contractors, vendors, customers, etc.
- **Internal Evidence** – Originating within the client organization: job tickets, payroll records, invoices, etc.
- **External Evidence** – Originating outside of the client organization: vendor invoices, bank statements, etc.
- **Analytical Evidence** – Computations resulting from analysis and verification

Audit Evidence (cont.)

There are also qualitative standards of internal auditing evidence

- **Sufficiency** – So factual, adequate and convincing that it would lead a prudent person to the same conclusion as the auditor.
- **Competence** – Reliable – the best obtainable reasonably.
- **Relevance** – a close relationship to its use. The facts and opinions have a logical sensible relationship to the issue.
Constructing Workpapers

- Constructing workpapers that sufficiently evidence work performed in an efficient and effective manner requires judgment, skill, and experience.
- Workpapers must be properly organized to fulfill their previously described objectives and purposes. This will also facilitate an organized review and standard approach.

Example Workpaper ToC

1. Table of contents.
2. Checklist evidencing completion of important quality-control tasks.
5. Administrative section (e.g., project authorization, budget, actual time record).
6. Audit program with all steps signed off as being complete.
7. Audit support for the work program steps tested.
8. Organizational documentation (e.g., flowcharts, policies, organization charts, as applicable) that assist in setting measurable standards to test by.
Workpaper Review

- Reviews of workpapers, in general, are completed by the direct supervisor. The senior auditor will review the staff auditor’s work, the manager will review both the senior’s and staff’s and the Director/CAE will perform an overall review.
- The detail of the review will decline as the work advances to upper levels. For example, the Director does not review the workpapers for correct cross-referencing, etc. (in most cases). This would be already reviewed by the Senior/Manager. The Director will focus his review on completeness and the compilation of findings and costs savings identified.

Workpaper Review – Common Issues

- Reviewers often note that workpapers are simply incomplete, unreadable, unintelligible, or unwisely constructed. Other more subtle deficiencies, such as the following, have also been noted:
- Narratives of discussions, meetings, and so forth, have no clear indication as to the relevance to the audit.
- Inability to literate the issue identified.
- Not properly identifying the source of information or the source of discussion.
- The auditor has failed to properly cross-reference copies of evidential matter to narratives, lead sheets, or tables summarizing sample results.
- Documenting the source of the population and how the sample was selected.
Workpaper Review –
Common Issues (cont.)

- Comparative analyses do not provide complete comparisons or analyses.
- Written conclusions are not supported by, or referenced to, evidence.
- Work papers do not include a definitive conclusion on test results.
- Copies of memoranda, invoices, purchase orders, and other forms of evidence have no reference or commentary as to why they are present.
- Copies of computerized reports (in whole or in part) have no indication as to why they are present.
- Copies of flowcharts, procedural narratives, and policy statements do not clearly relate to the audit objective.

Workpaper Best Practices

With respect to creating evidence (as opposed to obtaining copies), the auditor should follow these guidelines:

1. Devise a heading or title for the workpapers that accurately identifies the content.
2. Initial and date all workpapers.
3. State the purpose of the objectives in each workpaper.
4. Identify or list the evidence in a clear and traceable fashion. In effect, an audit trail should be created that would enable the audit procedure to be duplicated by the reviewer.
5. State the appropriate conclusion clearly and concisely.
6. Provide necessary references and cross-references to and from other relevant workpapers.
Example – General Workpaper Review Policy

- Cover Page is attached in this Excel Workbook. The Cover Page is not to be signed until the workpapers and audit are 100% complete.
- Each member of the audit team will be assigned an area to test and an area to review (if applicable) prior to the audit. Audit work is to be completed in the field - IA should not leave the field until audit work is 100% complete.
- Workpapers should be in soft copy and minimal hard copy writing should occur in the file. The person who performs the audit work should sign their initials and date at the top of the referenced workpaper.
- The reviewer should sign each workpaper after it is 100% complete.

Example – General Workpaper Review Policy (cont.)

- The audit workpapers should be reviewed for the following (in general):
  - Appropriate Referencing and Cross-Referencing
  - Sign-off by Auditor on the workpaper and on any notes completed.
  - Appropriate Conclusion reached on workpaper.
  - Objective of workpaper clearly stated
  - Appropriate support referenced and attached.
  - Population and Sampling methodology.
- All review notes are completed in hard copy form and addressed as such.
- Points written must be cleared by the author prior to the next level of review.
Key Elements

- **Source.** The name and title of the individual providing the documentation should be recorded to facilitate future follow-up questions or audits.
- **Scope.** The nature, timing, and extent of procedures performed should be included on each workpaper for completeness. It is also helpful to include a statement describing the purpose of the particular document with respect to the audit objective.
- **Reference.** A logical workpaper number cross-referenced to audit program steps and issues should be included.
- **Sign-off.** The preparer’s signature provides evidence of completion and accountability, which is an essential piece of any third-party quality review.
- **Tick mark legend.** A concise definition of all tick marks should be included on each audit workpaper or at a central location to clearly describe the work performed during the engagement.
- **Exceptions.** Audit exceptions should be documented and explained clearly on each workpaper using logical numbering that cross-references to other workpapers.

Other Workpaper Considerations

- Due to the significant variety of internal audit engagements and related workpapers, assessing the adequacy of audit documentation often can be difficult. The specific audit procedures performed can result in different documentation requirements.
  - For example, if the engagement involves a review of sensitive payroll information, the auditor likely would not be able to retain example information and instead would have to create a detailed memo explaining the procedures performed. The amount of auditor judgment used to determine any observations also will impact documentation requirements. Any assumptions, inferences, or other uses of judgment will need to be documented clearly and reviewed by appropriate levels of internal audit management.
Other Workpaper Considerations

- Finally, the quantity and severity of exceptions noted will require varying degrees of audit documentation. If there are no exceptions, one thorough walk-through example of procedures performed likely would suffice. However, if multiple significant exceptions are noted, internal auditors likely would need to obtain all related source documentation and provide detailed explanations for each exception.
  - Keeping these considerations in mind, internal auditors always should try to adhere to any standard in-house workpaper styles and templates. They also should exercise caution when relying on prior year workpapers, as the documentation may not meet current quality standards. Careful consideration of key audit workpaper characteristics and essential elements will improve the quality of audit documentation and reflect on the audit project itself.

6 Field Work Methodologies

- Observing is “a careful knowledgeable look at people, facilities, processes and things.
- Questioning This function is directly related to interviewing although the questioning can be exercised through the use of prepared questionnaires.
- Analyzing This function is a detailed examination by dividing a complex entity into parts to identify how the entity really works and if it is efficient and effective.
6 Field Work Methodologies (cont.)

- **Verifying** This function is confirming the truth, accuracy, genuineness or validity of something.

- **Investigating** This is an inquiry aimed at uncovering hidden facts and establishing the truth. It can also relate to searching for malfeasance, nonfeasance and misfeasance.

- **Evaluating** This simply is determining worth. It is the professional judgment process that precedes the internal auditor’s opinion. Sawyer identifies it as a “function that invades all of the above elements so as to determine the value of the result of the audit work, and also the audit process itself.”

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**Group Exercise – Analysis of Audit Results**
## Group Exercise – Analysis of Audit Results

What is the conclusion based on the results on the following page?
Exercise Answer
Audit Reports – What’s the Point?

- Why write an audit report?
- Where are we in the audit process?
- Why are you here?
Audit Reports – Let’s Make it Personal - EXERCISE

- How effective are audit reports?
- When do you use audit reports? For what audit types?
- Should it be formal or informal?
- Should it take 1 page or many pages?
- Who receives it?
- Who signs off?
- Should you include risk ratings/opinion?
- What is the report issuance turnaround time?

Auditor Guidance

- International Professional Practice Framework (“IPPF”)
- Governmental Auditing Standards (“Yellow Book”)
- Generally Accepted Auditing Standards (AICPA/ASB/PCAOB)
- State Requirements (vary)
The Institute of Internal Auditors

- Formed in 1941
- Headquartered in Altamonte Springs, Florida
- 130,000 members worldwide and growing
- Sets standards for practicing internal audit (IPPF)
- Conferences
- Research
- Guidance is somewhat loose

IIA IPPF

- Definition
- Code of Ethics
- Standards (attribute, performance, implementation)
- Position papers
- Practice advisories
- Practice guides
Attribute Standards

- 1000 – Purpose, Authority, Responsibility
- 1100 – Independence and Objectivity
- 1200 – Proficiency and Due Professional Care
- 1300 – Quality Assurance and Improvement

Performance Standards

- 2000 – Managing the Internal Audit Activity
- 2100 – Nature of Work
- 2200 – Engagement Planning
- 2300 – Performing the Engagement
- 2400 – Communicating the Results
- 2500 – Monitoring Progress
- 2600 – Resolution of Management’s Acceptance of Risks
Audit Report Writing - Guidance

  - 2400: Internal Auditors must communicate the engagement results
  - 2410: Criteria for Communications
    - Communications must include the engagement's objectives and scope as well as applicable conclusions, recommendations, and action plans.
  - 2420 Quality of Communications
    - Communications must be accurate, objective, clear, concise, constructive, complete and timely.

Audit Report Writing – Guidance (cont).

- 2410: Criteria for Communications
  - Communications must include the engagement’s objectives and scope as well as applicable conclusions, recommendations, and action plans
    - 2410.A1 – Final communication of engagement results must, where appropriate, contain the internal auditors’ overall opinion and/or conclusions.
    - 2410.A2 – Internal Auditors are encouraged to acknowledge satisfactory performance in engagement communications (What does this mean?).
    - 2410.A3 – When releasing engagement results to parties outside the organization, the communication must include limitations on distribution and use of the results.
    - 2410.C1 – Communication of the progress and results of consulting engagements will vary in form and content depending upon the nature of the engagement and the needs of the client.

- 2410.A1 - Final communication of engagement results must, where appropriate, contain the internal auditors’ overall opinion and/or conclusions. When issued, an opinion or conclusion must take account of the expectations of senior management, the board, and other stakeholders and must be supported by sufficient, reliable, relevant, and useful information.
  - **Interpretation:** Opinions at the engagement level may be ratings, conclusions, or other descriptions of the results. Such an engagement may be in relation to controls around a specific process, risk, or business unit. The formulation of such opinions requires consideration of the engagement results and their significance.

Audit Report Writing - Guidance (cont)

- 2420 Quality of Communications
  - Communications must be accurate, objective, clear, concise, constructive, complete and timely.
    - Accurate – no errors or omissions; stick to the facts
    - Objective – fair, impartial and unbiased
    - Clear – logical and easy to understand and are not subject to interpretation
    - Concise – to the point
    - Constructive – helpful
    - Complete – include all significant and relevant information
    - Timely - expedient
Audit Report Writing

- 2450 – Overall Opinions When an overall opinion is issued, it must take into account the expectations of senior management, the board, and other stakeholders and must be supported by sufficient, reliable, relevant, and useful information.
  - Interpretation: The communication will identify:
    • The scope, including the time period to which the opinion pertains;
    • Scope limitations;
    • Consideration of all related projects including the reliance on other assurance providers;
    • The risk or control framework or other criteria used as a basis for the overall opinion; and
    • The overall opinion, judgment, or conclusion reached.
- The reasons for an unfavorable overall opinion must be stated.

Audit Report Writing

- Why do we write audit reports?
  - Communicate results
  - Prompt action
  - Provide assurance
  - Why else?
Audit Report Writing

- Limitations on Audit Reports
  - What are some limitations placed on issuance of reports?
    • Time – deadlines
    • Authority – dictating an action plan
    • Legality
Contents of a Typical Audit Report

- Executive Summary
- Observations
- Appendices

- Audit Summary
- Audit Objectives
- Audit Scope
- Background
- Opinion (?)
- Overall Report Ratings (?)
- Standards Conformance Statement (?)
Contents of a Typical Audit Report

- Observations
  - Foundation
  - Condition
  - Cause
  - Effect
  - Recommendations
  - Action plans

- Appendices
  - Additional information
  - Exhibits
  - Policies and procedures
Executive Summary

- The most important piece of an audit report
- Reports are like Resumes – readability decreases significantly after the first page
- It is called an Executive Summary for a reason; executives will focus on this page – it has got to be good and catch the reader
- Keep it Short and Sweet – not all sections outlined need to be in the Executive Summary; hit the highlights
Executive Summary Audit Summary

- Why did we perform the audit?
- Why is this important?
- Why should management care about this report? How is this relevant?

Executive Summary Audit Objectives

- Audit Objectives
  - Purpose
  - Why did we perform this audit?
Write the following Audit Objective:
- Audit of HR policies
- Evaluation of knowledge and communication of P&P to employees

Example
- The purpose of the audit was to assess the reasonableness of Human Resource policies currently in place and to evaluate knowledge and communication of policies and procedures to employees.
Executive Summary: Audit Scope

- Audit Scope
  - Boundaries of the audit
  - *What is included vs. excluded*

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Executive Summary

Audit Scope *EXERCISE – 5 Minutes*

- Audit of SAP financial system
- *Covered the period June 1, 2009 - November 30, 2009*
- System went live June 1st.
Executive Summary Audit Scope

- Example
  - The audit of the SAP financial system covered the period from June 1, 2009 through November 30, 2009, as the system under review went live June 1st, 2009. Areas under review included X, Y, Z.

Executive Summary – Background

- Lays the foundation of the audit
- Gives history/reasons for audit
- Depicts methodology
- Lists other relevant information based on need of reader
IPPF Standards – Opinion

- Opinion - Standards
  - IPPF 2410.A1
    - Final Communication of engagement results must, where appropriate, contain the internal auditors' overall opinion and/or conclusions

IPPF Standards – Opinion (cont)

- Practice Advisory for 2410
  - Conclusions and opinions - the internal auditor's evaluations of the observations and recommendations' effects on the activities reviewed.
    » Usually put the observations and recommendations in perspective based upon their overall implications.
    » Clearly identify any engagement conclusions in the engagement report.
      » May encompass entire scope of engagement or specific aspects.
      » May cover whether operating or program objectives and goals are being met & whether activities under review are functioning as intended.
      » May include an overall assessment of controls or may be limited to specific controls or aspects of the engagement.
White Board Exercise: Why do we need an opinion in an audit report?

Executive Summary – Opinion

- Not every report needs an opinion
- Be careful! Use appropriate tone and language (to be covered later in the day)
- Opinion makes an impact and is a direct reflection of the auditor and the audit department
Executive Summary

Overall Report Rating

- Use caution on report ratings
- Problems arise from too much focus on rating and less focus on actual report content
- What are some advantages and disadvantages of using these ratings in your organization?
- Satisfactory, Needs Improvement, Needs Significant Improvement, Unsatisfactory (Color Coded)
- Like clothes– different forms and fashions fit different people/organizations

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Executive Summary – Standards Conformance Statement

- IPPF 2430 – Use there of conducted in conformance with the International Standards for the Professional Practice of Internal Auditing:
  - Internal auditors may report that their engagements are conducted in conformance with the International Standards for the Professional Practice of Internal Auditing only if the results of the quality assurance and improvement program support the statement.
Executive Summary – Standards Conformance Statement

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

- Example: This audit was conducted in conformance with the International Standards for the Professional Practice of Internal Auditing.
Executive Summary: Other Sections

- Background (better in appendix)
  - Further understanding of key messages
  - Describe any changes (why are we doing this?)

- Methodology/Approach (better in appendix)
  - General when in its own section
  - Not recommended; should be embedded as part of the observation itself

- Appendices (further explanation necessary)
  - Definition of ratings
  - Glossary
  - Abbreviations/acronyms
  - Additional support deemed necessary/relevant
Observation Components

- Foundation
- Condition
- Cause
- Effect
- Recommendations
- Action plans

Foundation

- It is what we are measuring against
- 3 types of Foundation:
  - Internal: Company’s policies and procedures
  - External: Regulatory/legal mandates
  - Best-Practice: Expectations in the company/industry & general research on the best way to do things.
Foundation – Continued

- Internal Foundation – Examples
  - Company travel & entertainment policy
  - Internal information, technology, security and access policies
  - Internal Human Resources code of conduct
  - Any policy/procedure in a company
  - Can be an informal process/procedure but formality assists in enforcement

Foundation – Continued

- External Foundation – Examples
  - Government requirements (HIPPA)
  - Sarbanes-Oxley Act of 2002
  - Tax regulations
Foundation – Continued

- Best Practice Foundation – Examples
  - GAAP
  - Segregation of Duties – general best practice
  - 3rd Party Vendor System Guidance
- What are other sources of best practice?

Condition

- Just the facts, ma’am!
- Various levels of detail (dependent on degree of finding and organization)
  - Cruising Altitude Summary – grouping of conditions combined along a commonality – “view from the top”
  - Just after Take Off Summary – conditions are grouped based on commonalities
  - Boarding Summary – individual records and detail; granular detail
Condition - Continued

What is the right level of detail?
  - Depends on:
    - Your organization and Audit Department’s internal standards and Audit Committee requirements
    - Importance of finding (risk rating)
    - Number of issues identified
    - Type of audit
    - Auditee
    - ETC, ETC, ETC.
    - What else?

Condition: Writing Good Summaries

- Aggregate – use numbers
- Find commonalities
- Use examples
- Don’t over-summarize
**Cause**

- What’s the difference?
- 3 Types of cause
  - Contiguous: the action or lack of action that led directly to the condition
  - Transitional (middle): the cause or causes that led to the proximate cause
  - Core: underlying cause

**Group Exercise**
EXERCISE

Write each of the three type of causes based on the following facts (condition)

- 27 employees were asked to verify knowledge of the IT security policy and compliance with the policy.
- 12 of the sample reviewed were not aware of the policy
- 5 were not found in compliance with current standards.

<table>
<thead>
<tr>
<th>Condition</th>
<th>27 Employees were asked to verify knowledge of the IT security policy and compliance with the policy. 12 of the sample reviewed were not aware of the policy and 5 were not found in compliance with current standards.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contiguous Cause</td>
<td>Employees were not aware of the policy as it was not given to new employees when hired nor was discussed when violations occurred.</td>
</tr>
<tr>
<td>Transitional Cause</td>
<td>Human Resources did not have a procedure in place to give the policy to new employees and IT was not aware of the lack of knowledge of the policy when violations occurred.</td>
</tr>
<tr>
<td>Core Cause</td>
<td>Communication is limited between Human Resources and IT and thus a lack of communications to employees.</td>
</tr>
</tbody>
</table>
Effect

- Risk or exposure to the company
- Levels of effect
  - Direct, one-time effect
  - Cumulative effect on the process
  - Cumulative effect on the organization
  - High-level, systematic effect

Effect – Practice Advisory

- Standard 2410
  - The risk or exposure the organization and/or others encounter because the condition is not consistent with the criteria (the impact of the difference).
  - In determining the degree of risk or exposure, consider the effect their engagement observations and recommendations may have on the organization’s operations and financial statements.
Effect - Example

| Condition                                      | 27 Employees were asked to verify knowledge of the IT security policy and compliance with the policy. 12 of the sample reviewed were not aware of the policy and 5 were not found in compliance with current standards. |
| Direct, one-time effect on the process          | 12 Employees were not aware of the policy thus violate the policy routinely due to the lack of knowledge. |
| Cumulative effect on the process                | The organization does not have an effective IT policy in place due to lack of communication of the policy to employees. |
| Cumulative effect on the organization           | The integrity of the IT control environment is compromised. |
| High-level, systematic effect                   | The organization has data integrity issues due to the lack of policy communication. |

Recommendations Practice Advisory

- 2007 Practice Advisory – Standard 2410
  - Engagement communications should include:
    - Recommendations for potential improvements
    - Acknowledgments of satisfactory performance
    - Corrective actions
    - Should be based on the internal auditor’s observations and conclusions and call for action to correct existing conditions or improve operations
    - May suggest an approach to correcting or enhancing performance as a guide for management in achieving desired results.
    - Recommendations may be general or specific
  » Example: under some circumstances, recommendation of a general course of action and specific suggestions for implementation may be desirable. In other circumstances, it may be appropriate only to suggest further investigation or study
Recommendations and Action Plans

- They describe what is to be done
- This is the real substance of the audit report; where auditors can really add value
- Any recommendations and action plans should be discussed and agreed to (if possible) with the auditee prior to report finalization.

Action Plans—Practice Advisory

- 2007 Practice Advisory – Standard 2410
  - As part of the internal auditor’s discussions with the engagement client, the internal auditor should try to obtain agreement on the results of the engagement and on a plan of action to improve operations, as needed.
  - If the internal auditor and engagement client disagree about the engagement results, the engagement communications may state both positions and the reasons for the disagreement.
  - The engagement client's written comments may be included as an appendix to the engagement report.
  - Alternately, the engagement client's views may be presented in the body of the report or in a cover letter.
Types of Recommendations and Action Plans

- **Cause focused** – Address actionable causes; identify and describe what is to be done to prevent recurrences of the condition.
  - Essential for significant or material observations but may not be needed for other, lower-rated observations

- **Condition focused** – address the condition identified and describe what will be done to correct the condition.
  - May not be required; varies from company to company

- **Recovery-focused** – address the consequence of the condition and describe what will be done to correct errors caused by the condition.
  - Not always appropriate based on the condition and may not be required in your company.

### Recommendation & Action Plans - Example

| **Cause-focused recommendation and action plan** | **Recommendation** - Management should enhance communication between Human Resources, Information Technology and Employees to provide the requisite knowledge and understanding on IT Policies and Procedures.  
**Action Plan** – The leadership team, including members of HR and IT, should meet at least monthly, to make sure employee training needs are met and reconcile all new employees to verify they have been made aware of requisite IT policies. |
| **Condition-focused recommendations and action plan** | **Recommendation** – Employees should be aware of the requisite IT policies to adhere to them.  
**Action Plan** – As part of the new hire checklist, IT policies are given to each new employee and each employee is asked to sign off stating they have read and agree to each. |
| **Recovery-focused recommendation and action plan** | **Recommendation** - Monthly, Human Resources should review all new hire paperwork to verify acknowledgment of policies and IT should, when any incidences are reported, verify knowledge of policies and make training available.  
**Action Plan** – Dalton Diedier, HR Manager, is now responsible for performing the reconciliation of new employees monthly.  
Additionally, IT is being trained on proper communications when incidents occur. |
IPPF Guidance

- 2420 Quality of Communications
  - Communications must be accurate, objective, clear, concise, constructive, complete and timely
IPPF Guidance

2420 Interpretation:
- Accurate communications are free from errors and distortions and are faithful to the underlying facts. Objective communications are fair, impartial, and unbiased and are the result of a fair minded and balance assessment of all relevant facts and circumstances. Clear communications are easily understood and logical, avoiding unnecessary technical language and providing all significant and relevant information. Concise communications are to the point and avoid unnecessary elaboration, superfluous detail, redundancy and wordiness.

IPPF Guidance (cont.)

2420 Interpretation:
- Constructive communications are helpful to the engagement client and the organization and lead to improvements where needed. Complete communications lack nothing that is essential to the target audience and include all significant and relevant information and observations to support recommendations and conclusions. Timely communications are opportune and expedient, depending on the significance of the issue, allowing management to take appropriate corrective action.
Report Optimization

- How do we make this report pop?
  - Quad CPV
  - ACRONYM: CCCPV
  - Cute Corny Curled Carrots Produce Vitamins

CCCCPV

- Clarity
- Coherence
- Concision
- Compelling
- Presentation
- Voice
Report Optimization – Voice Tones/Verb Tenses

- **WARNING** – this is not a grammar session! This is best practice on using tenses in reports
  - Foundation – best to use present since we are discussing a state currently still in place
  - Condition – a form of past since it has already occurred.
  - Don’t confuse tense with voice

---

Report Optimization
Verb Tenses - Examples

- Management was reviewing expense reports for proper adherence; one of the sample selected is an issue as no approval was noted.

**What is wrong with this?**
CRITERIA: Management reviews expense reports for proper adherence to policy and procedure.

CONDITION: We selected a sample of 30 and noted 1 selection as an issue, as it was not appropriately approved.

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Report Optimization - Tense

- Cause – be flexible; use past if the cause has been corrected and present if it has not.
- Effect – be flexible
  - Actual effects: present or various forms of past.
  - Potential effects: verb phrases using the potential mood or the conditional mood.
Report Optimization - Tense

- Recommendations – differs by organization
  - Imperative: uses the “do this” action verb at the beginning of the recommendation
  - Verb phrases using the conditional mood (“should”) or the obligative mood (“must” and “ought”)

Voice Tone

- Objectivity is key
- Can’t be auditors if we are biased
- Connotation (watch emotional words)
  - Failure
  - Negligent
- Projection (negative vs. positive)
Emotional Words Not to Use

- Failure
- Negligent
- Worthless
- Vigilant
- Superior
- Destructive
- Restricted
- Inferior
- Underestimated
- Worthless
- Confused
- Disorganized
- Discontent
- Galvanized
- Impertinent
- Minimized

Spelling and Grammar

- Accept/Except: Allow v. Exempt
- Affect/Effect: Influence v. Cause
- Conscious/Conscience: Being Aware v. One’s Moral Compass
- It’s/Its: It is v. possessive pronoun
- Than/Then: Comparison v. Relation to Time
- See Next Section

These are not caught on spell check as with many other errors!
How does audit enhance an organization's value?

- Follow-up is the answer, if an organization is to understand what value audit can have to improving operational integrity, efficiency and effectiveness.
- By looking at the prior audit recommendations of earlier work, auditors are able to assess if the agency, company or corporation has taken any action toward the report recommendations.
- If it has, a process is in place to try to assess what impact those recommendations had and to formally report the assessment and findings.
Why is Follow-Up Necessary?

- Required by Standards (see next slides)
- Real Value
- Verification of Issue Resolution
- Discovery Process

Why is Follow-Up Necessary? (cont.)

- Establishment of Standards and Process for Next Year/Audit
- Without Follow-Up, Audit is incomplete
- Get Off Your High Horse and Let’s Follow Things all the way Through
What do the Standards Say?

**Yellow Book**

- **4.7** Auditors should follow up on known material findings and recommendations from previous audits.

- **4.10** Auditors should follow up on known material findings and recommendations from previous audits that could affect the financial statement audit. They should do this to determine whether the auditee has taken timely and appropriate corrective actions. Auditors should report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit.

- **4.11** Much of the benefit from audit work is not in the findings reported or the recommendations made, but in their effective resolution. Auditee management is responsible for resolving audit findings and recommendations, and having a process to track their status can help it fulfill this responsibility. If management does not have such a process, auditors may wish to establish their own. Continued attention to material findings and recommendations can help auditors assure that the benefits of their work are realized.

**IPPF (IIA)**

- As required by the IIA’s *Standards for the Professional Practice of Internal Auditing* (Performance Standard #2500), internal auditors “should establish a follow-up process to ensure that management actions have been effectively implemented or that senior management has accepted the risk of not taking action.”
Audit Follow-Up Policy

- Every Process Needs a Good Policy!

- Clearly state standards so:
  - Auditors will know how to address
  - Auditees know what the standards are and there is no preferential treatment
  - General Timing Outline
Components of a Good Audit Follow-Up Policy

- A memorandum for senior management should be completed that notifies them that audit activities are underway and describes the follow-up process.
- Memo Contents:
  - timeframe of the project
  - copy of the outstanding findings
  - request that they distribute the findings to areas of focus and ask the managers to provide Internal Audit with the information requested
  - statement that these comments were previously distributed as part of an audit report or close-out letter and
  - notification that the results will be reported to Management.

Situations in which audit follow-up should occur

- Planning stage
  Formal plans for organizational changes have been created and approved by the appropriate level of management, with appropriate resources assigned and a reasonable timetable to be implemented agreed upon

- Preparation for implementation
  The entity has begun necessary preparation for implementation, such as hiring or training staff, or developing or acquiring the necessary resources to implement the recommendation.

- Substantial implementation
  Structure and processes are in place and integrated in some parts of the organization, and some achieved results have been identified. A timetable is in place for full implementation.

- Full implementation
  Structures and processes are operating as intended and implemented fully in all intended areas of the organization.

- A recommendation is no longer applicable
  The recommendation is obsolete due to time lapses, new policies, etc.

APMM – Action Plan Maturity Model

- Different levels of maturity model based on timing and completion of recommendations
- Example Progress Steps in an APMM:
  - No progress or insignificant progress
    Generating informal plans is regarded as insignificant progress.
  - Planning stage
    Formal plans for organizational changes have been created and approved by the appropriate level of management, with appropriate resources assigned and a reasonable timetable to be implemented agreed upon
  - Preparation for implementation
    The entity has begun necessary preparation for implementation, such as hiring or training staff, or developing or acquiring the necessary resources to implement the recommendation.
  - Substantial implementation
    Structure and processes are in place and integrated in some parts of the organization, and some achieved results have been identified. A timetable is in place for full implementation.
  - Full implementation
    Structures and processes are operating as intended and implemented fully in all intended areas of the organization.
  - A recommendation is no longer applicable
    The recommendation is obsolete due to time lapses, new policies, etc.
III. Timing/Method of Follow-Up

Whiteboard Exercise

- How do you Construct Your Audit Follow Up?
  - Every Finding
  - By Risk Rating
  - By Materiality
Audit Follow-Up

- Timing
  - Dependent on Priority of Issue
- Method
  - Dependent of Priority of Issue
  - Do we need to re-audit the process?

Follow-Up Timing

- *Is all of this dependent on the risk rating?*
- Dependent on Agreement of Deadline in Action Plan
  - Are there multiple tiers of follow-up?
  - Do we follow the progress of the action plans?
Follow-Up Methods
Ordered from Less to More

- Inquiry
- Observation
- Sample of One/Walkthrough
- Full Testing of Audit Issue
- Full Testing of Auditee

Summary

- Audit Follow-Up is Real Value Add
- Follow-Up depends on the Importance/Risk of Finding
- Constituents must be constantly managed
  - We are all in sales and must manage many different personality types!
Sources

- GAO Yellow Book
- IIA IPPF Standards
- Questions for Internal Auditors, IIA Research Foundation, 2002
- www.bilfaloo.com – Neurolinguistic Eye Cues
What is Internal Audit?

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

- **SOURCE:** IIA International Professional Practices Framework, e.g. the Red Book

Evaluation of Internal Controls

**Standard 2130 - Control**

- The internal audit activity should assist the organization in maintaining effective controls by evaluating their **effectiveness** and **efficiency** and by **promoting continuous improvement**.
- **2130.A1** - The internal audit activity must evaluate the adequacy and effectiveness of controls in responding to risks within the organization’s governance, operations, and information systems regarding the:
  - Reliability and integrity of financial and operational information;
  - **Effectiveness and efficiency of operations**;
  - Safeguarding of assets; and
  - Compliance with laws, regulation, and contracts.
- **2130.A2** - Internal auditors should ascertain the **extent to which operating and program goals and objectives have been established and conform to those of the organization**.
- **2130.A3** - Internal auditors should review operations and programs to ascertain the **extent to which results are consistent with established goals and objectives to determine whether operations and programs are being implemented or performed as intended**.
Defining Operational Auditing

- Widely used term but finding a uniformly accepted, common definition is difficult to identify. Common definition aspects:
  - Extension of the audit function into all operations of a business
  - Identification of opportunities for greater efficiency and economy, or to improve effectiveness in carrying out operational procedures
  - Control technique for evaluating the effectiveness of operating procedures
  - Audit that involves evaluating the efficiency and economy with which resources are managed and consumed
  - Auditing with a management viewpoint
The Three E’s of Operational Auditing

- Economy (Cost of Operations)
  - Is the organization carrying out its responsibilities in the most economical manner?
  - Considerations:
    - Adhering to sound procurement practices
    - Overstaffed as related to performing necessary functions
    - Allowing excess materials to be on hand
    - Using equipment that is more expensive than necessary, or
    - Avoiding the waste of resources

SOURCE: GAO Standards

The Three E’s of Operational Auditing

- Efficiency (or methods of operations)
  - Is the organization carrying out its responsibilities with the minimum expenditure of effort?
  - Operational inefficiency examples:
    - Improper use of processes and procedures
    - Inefficient work flow
    - Inefficient operating systems and procedures
    - Cumbersome organizational hierarchy and/or communication
    - Duplication of effort

SOURCE: GAO Standards
The Three E’s of Operational Auditing

- Effectiveness (results of operations)
  - Is the organization achieving results or benefits based on stated goals and objectives or some other measurable criteria?
  - Operational review includes:
    - Appraisal of the organizational planning system as to its development of realistic goals, objectives, and detailed plans
    - Assessment of the adequacy of management’s system for measuring effectiveness;
    - Determination of the extent to which results are achieved; and
    - Identification of factors inhibiting satisfactory performance of results

SOURCE: GAO Standards

The Operational Audit Triangle
Operational Audit Benefits

1. Identifying problem areas, related causes and alternatives for improvement
2. Locating opportunities for eliminating waste and inefficiency = cost reduction
3. Locating opportunities to increase revenues = income improvement
4. Identifying undefined organizational goals, objectives, policies and procedures
5. Identifying criteria for measuring the achievement of organizational goals and objectives
6. Recommending improvement in policies, procedures, and organizational structure
Operational Audit Benefits

7. Providing checks on performance by individuals and by organizational units
8. Reviewing compliance with legal requirements and organizational goals, objectives, policies, and procedures
9. Testing for existence of unauthorized, fraudulent, or otherwise irregular acts
10. Assessing management information and control systems
11. Identifying possible trouble spots in future operations
12. Providing an additional channel of communication between operating levels and top management
13. Providing an independent, objective evaluation of operations

Why is Operational Auditing Important?
What are the Benefits of an Optimization Audit

- Provides management with timely and relevant information
- Provides management with an independent view
- May identify problems at an early stage
- May identify waste inherent in current arrangements which may otherwise be covered up
- Assists management to evaluate management systems including reports, records and procedures
- Discovers whether managerial policies and practices are implemented and whether governmental requirements are complied with

Discussion
Relationship with Management

- Why does management need operational audits?
- What type of relationship will Audit need with Management to facilitate a review of operations?
- What kind of competencies do auditors need to perform operational reviews?

Exercise Answers
Attributes of an Effective Operational Auditor

- Curiosity (imagination)
- Analytical abilities
- Critical thinking
- Persuasiveness
- Strong interpersonal and communication skills
- Good business judgment
- Common sense (which is not very common)
- Objectivity
- Confidence
- Independence

Additional Attributes of an Effective Ops Auditor

- Ability to spot trouble areas – analyze a given situation and quickly determine what is the problem or the root cause.
- Ability to identify critical problem areas (chase cougars instead of kittens)
  - **80/20 Rule**: Operational auditing requires 80% common sense and 20% technical expertise & 80% of trouble areas cause 20% of the problems & that 20% cause 80% of the problems.
- Ability to take management’s position (hypothetically), to analyze the problem and ask questions from management’s perspective.
  - What management can and cannot control
- Skill to effectively communicate operational audit results.
  - Success is measured by degree with which recommendations are implemented (change agent) and implementation is a direct by-product of effective communication.
Operational Audit Skills and Abilities

- Cost analysis
- Flowchart preparation
- Evaluation of process flows and identification of controls
- Statistical sampling procedures
- Interviewing skills
- Deep understanding and awareness of varying performance standards of measurements
- Verification of data accuracy
- Use of analytical techniques, including:
  - Critical Path Method
  - PERT analysis
- Cost vs. Benefit analysis
- Communication skills (written and oral)

Mental Models and Belief Systems

- Emanate from top management (past and present)
- Overriding effect on the conditions with which operations within the company are carried out
- Can be helpful or a hindrance
- Become performance drivers
- Shape the direction of how employees will perform their functions
Examples

- The obedient child in the company survives and is promoted, while the rebellious child is let go or leaves the company
- Only managers can make decisions
- Employees need to be watched to do their jobs
- All functions should be organized in the same manner
- All employees are interchangeable
- Control the people, control the results
- Top management has the right to set all policies and procedures
- Organizational hierarchies ensure that things get done

Examples

- Employees cannot be trusted on their own
- Managers know more than employees
- Managers have a right to be obnoxious
- Management is the enemy
- Each function needs its own organizational structure
- There is a direct correlation between direct reports and importance to the organization
- Policing and control over employees ensure their compliance
The OA Audit Process

Operational Audit Phases

1. Assessment of Audit Risk
   a) Determine (based on management’s goals and objectives) where an operational review would add the most perceived value (tangible and intangible) – OA Assessment

2. Audit Planning
   a) Gain an Understanding of the Process
   b) Preliminary Survey
   c) Develop Operational Audit Objectives for the Area under Review (Audit Hypothesis)

3. Audit Programs

4. Field Work

5. Development of findings and recommendations
   a) Assess efficiency and effectiveness of control design and performance and related cost/benefit

6. Reporting

7. Follow-Up
1. Assessment of Audit Risk

- Does management understand what they want and the objectives of an OA audit?
- What do they want? What are they looking for?
- Are they management’s objectives or have they said “go find some money!”
- Make sure management understands what an OA audit is
  - Perception might be that Auditors do not have these capabilities

1. Assessment of Audit Risk (Cont.)

- Value can be viewed in many different ways
- What are the possibilities
- Aim for low hanging fruit
- What is obvious to you and your team might not be obvious to everyone else
  - It’s all about perspective
Group Exercise

Dallas Corporation

- We are performing a risk assessment/optimization assessment
- What will provide the maximum value for the organization?
- Analyze the following and based on the minimum amount of information available
Dallas Corporation

**Employees:** 1,000

**Geographic Dispersion:**
- Corporate Office: Dallas
- 5 Divisions, Similar Functions
  - Calgary
  - Miami
  - Denver
  - Boston
  - Omaha

**Background:**
- Company is 25 years old
- Sell Customized Software and Hardware to the Transportation Industry
- Grown through acquisition and consolidation
- Last Acquisition - Omaha 3 months ago
- Centralized Consolidation function but all other sites are standalone divisions
- Each division is run by a President, Ops Manager and Controller
- No consistency in employee roles and salaries

---

**Misc. Metrics**

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<th>Forecasted Revenues - YE 2011</th>
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|               | 272,000,000        | 42,500,000           | 277,000,000                   | 1,000         |
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</table>
Answers

- Denver, Calgary and Boston account for almost 80% of total revenues and net income.
- Calgary's Revenue is increasing by 20% but NI/Revenue is the lowest in the Company; based on their size, review of Ops Expenses could provide a significant boost to the bottom line.
- Calgary's Net Income based on Revenue is low but their Revenue per Employee is off the charts; this should be reviewed and expanded throughout the organization.
- Since Omaha is a very recent purchase, an operational review should be completed for best practices and possible process improvements.
- Why is the Denver and Boston markets profit being squeezed in 2011? How can we decrease expenses to match the decrease in Revenue?

Group Exercise

Low Hanging Fruit
Low Hanging Fruit

- From what we have learned about the purpose of an operational audit, what areas in most organizations would be RIPE for an operational audit? What about your organization – could you identify three areas that you would immediately think would benefit from an operational audit?

Low Hanging Fruit Exercise – Notes Page
Low Hanging Fruit

- Areas with large numbers in relation to other functions (revenues, costs, percentage of total assets, number of sales, units of production and personnel).
- Areas where controls are weak (e.g. lack of an effective manufacturing control system, management reporting system, or organizational planning and control system)
- Areas subject to abuse or laxity (e.g. there may be inventory and production controls that allow transactions to go unreported and undetected, uncontrollable time and expense reporting, and ineffective personnel evaluation procedures)
- Areas that are difficult to control (ineffective storeroom, shipping, or time recording procedures)
- Areas where functions are not performed efficiently or economically (duplication of efforts, unnecessary work steps, inefficient use of resources)
- Areas indicated by ration, change or trend analysis (wide swings up or down)
- Areas where management has identified specific weaknesses or needs for improvement (personnel functions, manufacturing procedures)

3. Audit Planning (See Appendix)

- Many ways to gain an understanding of the process
- Interviews
- Previous audit results
- SOX documentation and testing
- Same as normal audit step
5. Development of Findings & Recommendations

- From data gathering, there should be areas that are more advantageous to review than others ("high risk areas").
- Focus on areas where you can prove worth and value
  - Easy/quick wins, then expand
- Design issues can be very obvious
  - Many interviews will result in identifying design issues
- E/E & C/B can be viewed from many glasses (rose colored, etc)
  - Make sure your analysis is impartial and unbiased
- Can be valued in dollars, hours, time saved, employees transferred into other areas, etc.
  - Many different ways to value

6. Reporting

- Report can take the form or a normal audit report
- Watch language and tone
- Make sure facts and figures are accurate and explainable
7. Follow Up

- If they agreed to the audit report, make sure there are check points
- Check in on status
- Control/Process Maturity Model
  - Way to document progress
Unit VIII: Internal Control
Best Practices

Importance of Financial Related Controls and Processes

- Controls and Processes that provide monitoring and oversight over the numbers
- Like an organizational chart – most controls are connected and if you look close enough, you can locate the primary controls
How to Assess Financial Processes and Controls

- Understand process and look for gaps
- Connect the dots (e.g. assertions)
- Look for the top (top-down!)
- Foundation of controls for all processes

When/Why do we test Internal Controls?

- Financial Audits in accordance with GAGAS
  - Also includes report on internal control
- SOX Testing
- Operational Audits
- Good internal controls can decrease an audits inherent risk,
  Unreliable internal controls increase inherent risk
  - As inherent risk decreases, quantity of substantive testing decreases
Overview of COSO

- Committee of Sponsoring Organizations of the Treadway Commission (COSO)
  - Its major objective is to identify the factors that cause fraudulent financial reporting and to make recommendations to reduce its incidence.
  - COSO is sponsored by 5 main professional accounting organizations in the US:
    - American Institute of Certified Public Accountants (AICPA),
    - American Accounting Association (AAA),
    - Financial Executives Institute (FEI),
    - The Institute of Internal Auditors (IIA)
    - The Institute of Management Accountants (IMA).
- COSO has established a common definition of internal controls, standards, and criteria against which companies and organizations can assess their control systems.

» Source: www.coso.org
The COSO Definition of Internal Control

“Internal control is a process, effected by an entity’s board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations"

What is reasonable assurance?

Reasonable Assurance

Internal controls are to provide a **reasonable assurance** that the objectives of the system will be accomplished.

A high but not absolute level of assurance on an accountability matter. It rarely attainable due to factors as the need for judgment, the use of testing, the inherent limitations on internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature.
Control Environment

- Sets the tone of the organization – influencing control consciousness of its people
- Includes integrity, ethical values, competence, authority, and responsibility
- Acts as foundation for all other components of control
- Pervasive influence on all the decisions and activities of an organization.
- Effective organizations set a positive “tone at the top”.

COSO Internal Controls Cube

- Operation
- Financial Reporting
- Compliance
  - Monitoring
  - Information & Communication
  - Control Activities
  - Risk Assessment
  - Control Environment

- UNL Activity A
  - Activity 1
  - Activity 2

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Risk Assessment

- Identification and analysis of relevant risks to achieving the entity’s objectives – forming the basis for determining control activities
- Risks are internal & external events (economic conditions, staffing changes, new systems, regulatory changes, natural disasters, etc.) that threaten the accomplishment of objectives.
- Risk assessment is the process of identifying, evaluating, and deciding how to manage these events... What is the likelihood of the event occurring? What would be the impact if it were to occur? What can we do to prevent or reduce the risk?

Control Activities

- Tools - policies, procedures, processes - designed and implemented to help ensure that management directives are carried out.
- Range of activities, including approvals, authorizations, verifications, recommendations, performance reviews, asset security, and segregation of duties
- Help prevent or reduce the risks that can impede the accomplishment of objectives.
- Occur throughout the organization, at all levels, and in all functions.
Information and Communication

- Pertinent information identified, captured, and communicated in a timely manner
- Access to internally and externally generated information
- Flow of information that allows for successful control actions from instructions on responsibilities to summary of findings for management action
- Effective information and communication systems enable the organization’s people to exchange the information needed to conduct, manage, and control its operations.

Monitoring

- Assessment of a control system’s performance over time
- Combination of ongoing and separate evaluation...*Have controls become outdated, redundant, or obsolete?*
  - *Respond to dynamically changing conditions*
- Management and supervisory activities
- Internal audit activities
- Internal control systems must be monitored to assess their effectiveness... *Are they operating as intended?*
What are Internal Controls?

What Do We Do on a Daily Basis that Involves Internal Control?

- Lock-up valuable belongings
- Keep copies of your tax returns and related support
- Balance your checkbook
- Keeping passwords unique and separate
- Planning Ahead
- Home and Car Insurance
- Seat Belts
- Physical Control of Credit Cards
Why are Internal Controls Important?

- Compliance with applicable laws and regulations.
- Accomplishment of the entity’s mission.
- Relevant and reliable financial reporting.
- Effective and efficient operations.
- Safeguarding of assets.

What is the Risk of Weak Internal Controls?

**Business Interruption**
- system breakdowns or catastrophes, excessive re-work to correct for errors.

**Erroneous Management Decisions**
- based on erroneous, inadequate or misleading information.

**Fraud, Embezzlement and Theft**
- by management, employees, customers, vendors, or the public-at-large.
What is the Risk of Weak Internal Controls?

Statutory Sanctions
- penalties arising from failure to comply with regulatory requirements, as well as overt violations.

Excessive Costs/Deficient Revenues
- expenses which could have been avoided, as well as loss of revenues.

Loss, Misuse or Destruction of Assets
- unintentional loss of physical assets such as cash, inventory, and equipment.

What is the Benefit of Strong Internal Controls?

- Providing appropriate checks and balances.
- Reducing and preventing errors in a cost-effective manner.
- Ensuring priority issues and risks are identified and addressed.
- Protecting employees & resources.
- Having more efficient audits, resulting in shorter timelines, less testing, and fewer demands on staff.
1. Separation of Duties

- We will perform a detailed review of segregation through the next two days
- Divide responsibilities between different employees so one individual doesn’t control all aspects of a transaction
- Reduce the opportunity for an employee to commit and conceal errors (intentional or unintentional) or perpetrate fraud
  - Most employees do not want too much responsibility or opportunity
2. Documentation

- Critical decisions and significant events...typically involving the use, commitment, or transfer of resources.
- Transactions - enables a transaction to be traced from its inception to completion.
- Policies & Procedures - documents which set forth the fundamental principles and methods that employees rely on to do their jobs.
- Controls – should be documented to be evidenced.
  - Is there a grey area?

3. Authorization & Approvals

- Management documents and communicates which activities require approval, and by whom, based on the level of risk to the organization.
  - Tiered approvals
- Ensure that transactions are approved and executed only by employees acting within the scope of their authority granted by management.
4. Security of Assets

- Secure and restrict access to equipment, cash, inventory, confidential information, etc. to reduce the risk of loss or unauthorized use.
- Perform periodic physical inventories to verify existence, quantities, location, condition, and utilization.
- Secure access to key IT resources/systems
- Base the level of security on the vulnerability of items being secured, the likelihood of loss, and the potential impact should a loss occur.

5. Reconciliation & Review

- Examine transactions, information, and events to verify accuracy, completeness, appropriateness, and compliance.
- Base level of review on materiality, risk, and overall importance to organization’s objectives.
- Ensure frequency is adequate enough to detect and act upon questionable activities in a timely manner.
- Tiered level reviews
Controls Applicable to All

- EXERCISE – Based on your view of internal controls, what controls apply to all processes regardless of type?

The foundation of our controls home!

Please Write Your Answers Below
ANSWER

- Segregation of Duties
- Physical and IT Access
- Review and Reconciliation Controls (Management Oversight)
  - Balance Sheet Reconciliations
  - JE Reviews
- Tiered Approvals
- Pre-numbered documents
- Policies and Procedures

Testing Controls

- Walkthroughs
- Observation
- Documentation
  - Did it occur if not documented?
- Substantive testing
Unit VIII: Integrated Auditing
Operational and SOX Similarities

What is a SOX Audit?

- Compliance with requirements outlined in the Sarbanes-Oxley Act of 2002
- Controls-based testing, including documentation of processes and procedures and testing of key, material processes and controls
Operational and SOX Similarities

What is an Operational Audit?

Overall goal is to provide the management team with practical, strategic recommendations to:

– Identify cost saving opportunities,
– Identify revenue enhancement opportunities,
– Meet financial audit requirements (provide the necessary assurance to regulatory or grantor agencies, board or management), and/or
– Overcome risks and take advantage of opportunities

Operational audits are big-picture, open-ended reviews
## Operational and SOX Similarities

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<th>SOX</th>
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<tr>
<td>Identification of Inefficient/Ineffective Processes?</td>
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<tr>
<td>Interviews with Personnel?</td>
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<tr>
<td>Testing to Verify Current Process is in Place and Functioning as Intended?</td>
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</tr>
<tr>
<td>Identification of Potential Fraud/Segregation Issues?</td>
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<tr>
<td>Identification of Efficiency/Cost Savings Initiatives?</td>
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### Example "What Can Go Wrong" Questions - Divisional SOX Compliance Review - Cash Receipts

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<tr>
<th>Assertion</th>
<th>Objectives of Operational Audit of Cash Receipts</th>
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<tbody>
<tr>
<td>What ensures that cash receipts are recorded when received?</td>
<td>Review policies and procedures and determine if they are in-line with best practices and are currently in place and adhered to.</td>
</tr>
<tr>
<td></td>
<td>Review procedures for depositing cash and determine if process, personnel and access are appropriate.</td>
</tr>
<tr>
<td></td>
<td>Determine if the employees who have access to cash and related G/L accounts are appropriate.</td>
</tr>
<tr>
<td></td>
<td>Review the timeliness of cash received at the bank versus posted on the general ledger.</td>
</tr>
<tr>
<td>What ensures that cash receipts recorded equate to amounts deposited?</td>
<td><strong>Completeness, Existence/Occurrence</strong> X X</td>
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<td>Measurement/Valuation</td>
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<tr>
<td>What ensures that cash receipts/transfers are recorded in the correct period?</td>
<td><strong>Completeness</strong> X</td>
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<tr>
<td>What ensures that duplicate postings of cash receipts are not made to the general ledger?</td>
<td><strong>Completeness, Existence</strong> X</td>
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**X - Similar Objectives for Each Audit Process**
Financial and SOX Similarities

- In order to test many SOX controls, substantive auditing is necessary
  - Verification the control is being performed as documented
  - Integrates with Financial Auditing
- Examples
  - Prepaid/Accruals
  - Financial Statement Close
Audit Synergies

- Cost Savings Opportunities
- Financial Audit Requirements
- Operational Auditing
- Financial Auditing

- SOX Compliance Testing
- Operational Inefficiencies
- Revenue Enhancement Opportunities
Elements of Preliminary Work

- Define Audit Objectives
- Knowledge Gathering
- Authoritative Research
- Interview Management
- Internal Controls
- Walkthroughs
- Preliminary Risk Analysis
- What Else Can we Provide?
- Coordinating Resources

REGARDLESS OF AUDIT TYPE -> THESE STEPS ARE NECESSARY!
The Integrated SOFT Audit - Definition

An integrated S.O.F.T. (“SOFT”) audit is an efficient vehicle where financial, compliance, and operational objectives intersect and the most relevant and material tests are completed based on a comprehensive risk and cost/benefit analysis.

By integrating the audit approach, internal audit will be able to:

S - Perform SOX compliance testing that is valuable to management and the Company.

O - Perform operational reviews that can enhance shareholder value through control improvement, improved risk management, operational efficiencies, and direct cost savings.

F - Perform financial statement testing that can be relied upon by external auditors in some cases.

T - Complete information technology testing in related areas as well as compliance reviews in non-financial areas (such as health and safety, labor law compliance, etc) – transaction auditing.
Integrated Audit – the natural similarities

- IT Auditing
- Controls Auditing
- Financial (substantive) Auditing
- Operational Auditing

Continuous Auditing
ERM/GRC
Compliance/Regulations
IX. Fraud Red Flags
Fraud & Audit

- Audits are not designed to detect fraud
- Goal: Determine whether the financial statement is free from material misstatements.
- Auditors test only a small fraction of transactions
- Auditors must:
  - Be aware of the potential of fraud
  - Discuss how fraud could occur
  - Delve into suspicious observations and report them
Auditor Responsibility

All auditors should have at least:

- Some semblance of fraud training/experience
- Creation/Involvement of the anti-fraud assessment
- Solid understanding of measures intended to prevent and detect fraud
- Awareness of financial fraud schemes and scenarios and knowledge of forensic investigations
- Ability to detect financial statement fraud, which requires a firm understanding of financial reporting standards
Influencers of Fraud

- Situational Pressure
- Opportunity
- Rationalization
Fraud Risks to Consider

- Fictitious customer orders are created
- Revenue is fully recognized when a significant risk of return exists
- Inventory counts or valuation of inventories are falsified
- Royalties/Taxes are avoided
- CEO/CFO put pressure on accounting staff to be "creative"
- Breach of a major debt covenant
- Reserves (of all types) are improperly recorded or adjusted
- Changes in accounting policy are not reported
- Business is directed to vendor in return for personal benefit
- Officers/managers violate expense policy
- Dates on shipping documents are altered
- Assets are valued based on false or invalid assumptions
- Assets are expensed
How is Fraud Discovered?

- **Tips**: 46.2% (Black 2008), 34.2% (Red 2006)
- **By Accident**: 20.0% (Black 2008), 25.4% (Red 2006)
- **Internal Audit**: 19.4% (Black 2008), 20.2% (Red 2006)
- **Internal Controls**: 23.3% (Black 2008), 19.2% (Red 2006)
- **External Audit**: 9.1% (Black 2008), 12.0% (Red 2006)
- **Notified by Police**: 3.2% (Black 2008), 3.8% (Red 2006)

Black 2008 (top) - Red 2006 (bottom)
Categories of Fraud Risk

- **Misappropriation of Assets**
  - involve the theft or misuse of an organization’s assets. (Common examples include skimming revenues, stealing inventory, and payroll fraud.)

- **Corruption**
  - fraudsters wrongfully use their influence in a business transaction in order to procure some benefit for themselves or another person, contrary to their duty to their employer or the rights of another. (Common examples include accepting kickbacks and engaging in conflicts of interest.)

- **Fraudulent Financial Statements**
  - falsification of an organization’s financial statements. (Common examples include overstating revenues and understating liabilities or expenses.)
What is a Trusted Employee?

- Independent
- Almost all work alone
- Never take vacation
- Knows everything
- Work long hours
  - To work early/leave late

- We trust employees too much (blind trust)
- Must use trust but verify concept (monitoring)
What is an “At Risk” Employee?

- Employee work habits
  1. Come to work early or leave late
  2. Works nights and weekends
  3. Seldom missing for leave or vacation
  4. Reports to office during brief absences
  5. Ask others to hold work while gone
  6. Knows too much
  7. Too helpful or too involved

The Issue is Control
Potential Transaction Red Flags

Unusual transactions:
- Unusual timing, too frequent or infrequent
- Unusual amount: too much or too little
- Unusual participant: involves unknown or closely-related party
- Voided checks or receipts, with no explanation
- Insufficient supervision
- Pattern of adjustments to accounts
- Different addresses for same vendor, or vendors with similar names
Types of Accounts Receivable Fraud Schemes

- Check for cash substitution
- Lapping
- Eliminating certain customer accounts
  - Do not want to work the collections
  - Monitor write-offs
- Fictitious account adjustments
Steps to Detect Accounts Receivable Fraud

1. Reconcile balances of control account with subsidiary accounts (detects one-sided transaction schemes)
2. Agree total credits in subsidiary accounts to cash collections/deposits
3. Compare total customer/meter book accounts to the active customer accounts in the computer system (detects eliminated accounts)
4. Review account write-offs to ensure all transactions are authorized, approved, and properly supported using an “exception report” documenting the universe of these high risk transactions (detects lapping schemes)
5. Consider confirming delinquent account balances with customers if significant (detects lapping schemes and other manipulations)
6. Review billing rates for propriety (identifies account manipulations)
7. Purge Credit Balances
Accounts Payable: Fraud Risks

- Debit Balances
- Large/Old balances
- New Suppliers (review of process)
- No payment date
- Unrecorded liabilities
Purchasing – Fraud Tests

- Compare purchases to inventory flow
- PO Boxes
- Invoice address different from contract
- Invoice # with no broken sequence
- Duplicates
Common T&E Fraud

- Expense misclassification - Common scam involving submission of personal restaurant, hotel or vacation expenses as business expenses

- Creating fictitious expenses - Include taking blank receipt forms from restaurants or limousine services and filling them out...or creating completely bogus receipts on a computer

- Claiming multiple reimbursements:
  - Submitting several types of documentation for the same expense -- such as a an airline ticket stub for the same flight
  - Submitting multiple copies of the same documentation to different departments or budget
  - Submitting an expense report, waiting a month or two and then simply submitting it again
Payroll Concepts to Remember

- Payroll = 50-80% of all expenditures
- Every employee can falsify own payroll
- Know that employee time cards are blank checks and can be falsified (after approval) – look for a straight line from source to approval to payroll
- No one should approve their own time sheet
Payroll Fraud Schemes

- Individuals receive more pay than authorized – fraud of choice
  - most common
- Employees issue checks to themselves:
  - For too much money
  - For work not performed
  - For unauthorized vacation buy-outs
- The fraud can involve:
  - Normal payroll
  - Overtime
  - Vacation and sick leave
- Primary suspects:
  - Payroll employees
  - Department timekeeper
The Five Most Common Payroll Fraud Schemes

- Ghost employees
- Mid-month payroll draws not deducted from end-of-month payroll
- Unauthorized employee pay
- COBRA program abuses
- Advance release of withheld funds
Fraud Red Flags
Employee Red Flags

- Significant change in lifestyle: New wealth
- Financial difficulties may create need
  - Gambling or drug addiction
  - Infidelity is an expensive habit
- Criminal background
- Chronic legal problems: person looks for trouble
- Dishonest behavior in other parts of life
- Beat the system: Break rules commonly
- Chronically dissatisfaction with job
Organizational Red Flags

- Lack of communication of expectations
- Too much trust in key employees
- Lack of proper authorization procedures
- Lack of attention to detail
- Changes in org structure
- Tendency towards crisis management
Financial Document Red Flags

- Missing/Altered documents
- Excessive number of voided documents
- Documents not numerically controlled
- Questionable handwriting or authorization
- Duplicate payments
- Unusual billing addresses
- Address of employee same as vendor
- Duplicate or photocopied invoices
- Invoices not folded for envelope
Accountability and Control Red Flags

- Lack of separation of duties
- Lack of physical security and/or key control
- Weak links in chain of controls and accountability
- Missing independent checks on performance
- Lax management style
- Poor system design
- Inadequate training
How to Minimize Fraud Risk

- Adhere to policies/procedures (especially documentation and authorization)
- Identification/Understanding of key controls and fraud areas
- Ensure physical security over assets
- Provide proper training to employees
- Independently review and monitor tasks
- Provide for segregation of duties
- Clear lines of authority
How to Minimize Fraud Risk

- Rotate duties in positions susceptible to fraud
- Ensure employees take regular vacations
- Schedule regular independent audits of areas susceptible to fraud
- Ensure background checks for employees handling financial transactions (or all employees?)
- Make sure internal controls are adhered to
- Ask for documentation
- Ensure that one person does not have total responsibility for a process
- Evaluate performance regularly
- Report suspicious activity
Unit X: Crucial Communications

Discussion – Why is Communication Important?
Why is Communication Important?

- Without proper communication, all business will eventually fail
- “Effective communication starts with listening” – Robert Gately
- “The most basic of all human needs is the need to understand and be understood. The best way to understand people is to listen to them.” - Ralph Nichols
  - Avoid problems
  - Save time (efficiency and effectiveness)
  - Transparency

Why Do We Communicate?

- Inform
  - Provide Information
  - Give Directions
  - Educate
- Inquire
  - Solicit/collect information
- Request
  - Ask for action
- Persuade
  - Prompt action
- Build Relationships
  - Foster goodwill
7 C’s to Effective Communication

Clear

- Focused
- No question about intention or objective
- Eliminate irrelevance
- Embrace logic
- Straight forward
Which is more clear?

- Please take care of the assignment I emailed you a few weeks back regarding the memo on accounting.
- Brent, a few weeks back (May 12th) I emailed you concerning the accounting for our new acquisition (ABC Company). I wanted to check in and see the status of the memo. Please let me know at your earliest convenience.

Concise

- Minimize word usage but....
  - Do not spare words for the sake of being brief
- Use useful words, not space killers
- Do keep your audience engaged and interested
Complete

- Be thorough, paint a picture
- Beginning to end
- Get your point across
  - Introduce
  - Support
  - Reiterate

Captivating

- Interesting
- Know when to dive into an area and know when you are giving too much detail
  - Subject matter must be flexible
- Command more attention and better responses
- Compelling language that encourages action
- Know your objective and consistently reiterate
When is too much detail?

- Start high and dive deeper
  - If presentation is an overview, give an overview
  - If presentation is a deep dive, give a deep dive
  - What is the audience’s expectations?
- Read the audience’s eyes, demeanor and physical cues

Which is more captivating?

- Thank you for your presentation this morning; it was exciting, endearing and very engaging. I would like to follow up this presentation with a request for the presentation slides as I would like to pass them on to my superiors. Thank you so much.
- Thanks.

- Question – Is the latter too concise?
Conversational
- Easy to follow and understand
- Speak with an audience, not to them
- Personalize the experience, make them connect

Courteous
- Professional demeanor
- Friendly
- Approachable
- Talk with not to
Concrete

- Specifics and certainty
- No ambiguity
- Direct and to the point

7 C’s to Effective Communication - Summary

1. Clear – Focused; no question on intentions or objectives; eliminate irrelevance & embrace logic
2. Concise – Minimize word usage but do not spare words just to be brief
3. Complete – Be thorough; paint a picture; be truthful
4. Captivating – Interesting; compelling and impelling language that encourages action
5. Conversational – Easy to follow and understand
6. Courteous – Professional demeanor; conversational but not offensive
7. Concrete – Specifics and certainty
General Communication Issues

Personal vs. Professional

- Separation of Church vs. State or Personal vs. Professional
- Know the difference
- Be unemotional
- Personal attack vs. getting to the root of the problem
- Casualness of emails (know your audience)
Miscommunication

- #1 cause of unnecessary conflict
  - Happens in many cases due to the mode of communication
    - Emotion/feelings are difficult to interpret via email, Blackberry, IM, etc.
- People always fear the worst outcome
  - “Hey, can we talk?”
- Assumptions take on a world of its own

Form of Communication

- When do you email vs. phone vs. in-person (addressed later in presentation)?
- Messages are easily confused or misinterpreted via email
- When should emails be responded to via phone or in-person?
- When is IM appropriate?
- When should you respond to emails via Blackberry?
People inherently do not like confrontation
- Transparency and honesty can breed confrontation but that can be healthy confrontation
  - Lack of transparency and honesty breeds negative confrontation
- Caused in many cases by miscommunication
- Optimize your confrontations....
Optimize Your Conflict Resolution

- Personally confront the issue
- Make your initial statement and stop talking
- Avoid arguing during the confrontation
- Know the resolution you want prior to the confrontation
- Focus on the real issue of the confrontation
- Acknowledge feelings

Fact Conflicts

- Conflicts over facts are usually the easiest to resolve since facts are subject to independent verification
- In these cases, the questions will concentrate on gathering the information needed to confirm or refute the facts
- Once everyone is satisfied that the facts are correct, the conflict will be resolved
- Walk through the steps to lead to the conclusion – gain agreement on each step
Feelings & Perceptions

- Well-intentioned recommendations may sometimes be perceived as criticisms or even accusations
- The natural human response to a perceived threat is “fight or flight”
- Defensive and making excuses
  - Make the situation not personal
  - Look for cost/benefit
  - Respect the other person – who knows more?
  - Make sure they understand – you are doing your job

Personalities

- We are not psychologists
- Researchers have found that most differences in working styles result from differences in two basic characteristics:
  1) Ask vs. tell
  2) task-oriented vs. people-oriented behavior
- Manage the situation and person
Individual Values

- May be no immediate resolution
- Generally not subject to negotiation or compromise
- Asking questions about fundamental values can actually be counter-productive
  - Avoid deep conflict
  - Stay at a higher level
  - Find a mutual ground/understanding

Listening Techniques
Listening Optimized (1 of 2)

- Ignore phone calls during the conversation and abstain from multitasking
- Look at the other person and focus on the words and meanings
  - Content and intent
- Avoid interruptions
- Resist jumping to conclusions
- Concentrate on the flow and back and forth of the conversation, rather than becoming hung up on bits of information or parts of past conversation

Listening Optimized (2 of 2)

- Take on the responsibility of listening: being bored, not liking the speaker, or disagreeing with what he or she has to say does not excuse you from actively listening
- Consider body language and respond with both words and actions, taking into account your own body language and concern
- Restate key points to ensure accuracy and prevent potential misunderstandings
Listening is....

- A major part of communication
- A major factor in miscommunication
- A great asset when optimized

Verbal (1 of 2)

- Say what you mean and say it clearly
- 2 ears, 1 mouth
- Stay present
- Make eye contact
- Ask questions for clarification
Verbal (2 of 2)

- Acknowledge feelings
- Restate or paraphrase
- First understand, then be understood
- Give nonverbal feedback (details in coming slides)
- Silence
- Take ALL the information to heart (verbal & nonverbal)
- Get permission

In Person

- Depending on the study being quoted, we remember a dismal 25-50% of what we hear.
- Good communication skills require a high level of self-awareness. By understanding your personal style of communicating, you will go a long way towards creating good and lasting impressions with others.
- Become an active listener and eliminate bad habits!
Active Listening

- When the listener provides feedback (verbal and/or non-verbal) to the speaker demonstrating to that the speaker’s message has been understood and will be retained

Verbal Active Listening Techniques (1 of 2)

- Using encouraging words and reassuring sounds to convey interest (“I see.”)
- Restating in your own words what the person said
- Repeating exactly what the person said (“Mirroring”)
- Reflecting to show you understand how they feel (“You were pretty upset by this...”)
**Verbal Active Listening Techniques (2 of 2)**

- Probing the interviewee’s initial response in order to expand and/or clarify the information given (“Please tell me more about that”)
- Summarizing (“these seem to be the main ideas you stated”)

**Non-Verbal Active Listening Techniques**

- Maintaining appropriate eye contact with the interviewee
- Occasionally nodding affirmatively to display understanding and interest
- Using expectant pauses to indicate to the interviewee that more is expected
“No-Nos”

- Sighing
- Frowning
- Blank stares
- Raised eyebrows
- Fidgeting
- Foot bouncing
- Pencil tapping
- Checking Blackberry/iPhone

Barriers to Active Listening (1 of 2)

- Not keeping an open mind by letting biases interfere
- Jumping to conclusions
- Interrupting or debating the interviewee: seek understanding first!
- Monopolizing the conversation (70/30 rule)
- Thinking ahead to your next question
Barriers to Active Listening (2 of 2)

- Reading documents provided by the presenter
- Not suppressing disruptive habits such as finger drumming or pencil tapping
- Assuming you know what the presenter meant and not requesting clarification

Summary

- Communication cannot be reviewed in an hour!
- Communication is more or as important than any other skill we have.
- Get better at communication, get better at work and life!
- Accountants are always knocked for their lack of communication skills.
- Listening is as important as speaking. Improving both will improve everything.
What is an Audit Interview?

- Small, personal, controlled conversational meeting in which auditors obtain needed information from people who have it.
- Conversation with an agenda.
Interview = Evidence?

- Four kinds of audit evidence:
  - Physical
  - Documentary
  - Analytical
  - Testimonial
- QUESTION – Which is the strongest and which is the weakest?
- QUESTION – What is an interview?

Interview Evidence

- STRONGEST = Physical
- WEAKEST = Testimonial
- Interviewing is......

Testimonials

- Allegations/Opinions are NOT evidence.
Steps in the Audit Interview Process

1. **Planning/Preparation**
   a. Objectives
   b. Types of Questions
   c. Background on Interviewee
   d. Information Requests
   e. Participants
   f. Location
   g. Time

2. **Conducting the Interview**
   a. Agenda
   b. Environment
      i. Interviewer(s)
      ii. Participants
   c. Interview Variations
   d. Recording the Interview
   e. Ending the Interview

3. **Interview Results**
   a. Professional Skepticism
   b. Documenting the Interview

4. **Follow Up**
Audit Interviewing - Preparation

Types of Interview Questions

<table>
<thead>
<tr>
<th>Type</th>
<th>Advantage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open Ended</td>
<td>Detailed explanations and descriptions; conversation can veer in numerous directions</td>
</tr>
<tr>
<td>Closed</td>
<td>Simple Information, Yes/No</td>
</tr>
<tr>
<td>Qualifying</td>
<td>Establishes witness credibility</td>
</tr>
<tr>
<td>Range</td>
<td>Provides general areas</td>
</tr>
<tr>
<td>Motives</td>
<td>Reveals why people did/did not do</td>
</tr>
<tr>
<td>Opportunity</td>
<td>Reveals whether people could have done</td>
</tr>
<tr>
<td>Lead to Others</td>
<td>Sets stage for subsequent questions</td>
</tr>
<tr>
<td>More Info</td>
<td>Asks that more information be provided</td>
</tr>
</tbody>
</table>
What Questions Should You Not Ask

- Irrelevant – do not waste anyone’s time (ice breakers are acceptable but some express sensitivity to personal questions; once this is done, move into the meat of the interview).
- Inadequate Answers – do not ask question that will return answers other than you need. EXP:
  - “Do you know when this occurred?”
    • They can answer yes without providing a real answer (who and when)
- Multiple Answers – Avoid questions that might not have answers or that restrict possible answers. EXP:
  - “Were you trained formally or did you learn on the job?”
    • Restricts answers to two when more are possible.

- Answer-suggesting questions – “Don’t you think this is the right way to do it?”
- Accusatory – do not ask questions that directly/indirectly accuse anybody of misgivings.
- Sensitive and Personal – what do we not talk about at work???
Managing Yourself - Interviewing

**Location**
- Their Office
- Your Office
- Meeting Room
- Teleconference
- Web Conference

**Interview Location**
- Convenient, private, comfortable setting with good acoustics
- Select based on appropriateness and convenience to each party, available space, seating arrangements, relative quiet and good air quality.
- Conducive to open discussion
  - Free of disruptions
  - Refreshments available
- Conference room is best
- Must feel comfortable (both) parties can speak openly
Managing Yourself - Interviewing

Time
- Number of Questions and Information Requests
- Availability of Participants
- Number of Participants
- Interview Venue
- Use of Pre-reads and/or Questionnaires

Conducting and Controlling Audit Interviews
Eight Stages of an Interview

1. Defining its purpose
2. Identifying information needed from interviews
3. Identifying people to interview
4. Preparing for the interview
5. Conducting and controlling the interview
6. Recording the interview
7. Analyzing the results
8. Documenting the analyze results in the working papers

Interviewing Checklist

- What are your audit objectives?
- What information do you need?
- Why must you get it from interviews?
- Who might have that information?
- What position levels will you interview for that information?
Managing Yourself - Interviewing

Meeting
- Agenda
- Environment
  - Interviewer(s)
  - Participant(s)
- Listening
- Recording
- Summarizing

Interview Management
- We are here to help; we are not the enemy!
- Gain Valuable Insight into the Auditee
- Get Buy-In
- Access to Knowledge and Skills
- Access to Undocumented Knowledge
- Access to Leads & Rumors
- Understand Wants/Needs, & Expectations
- Coordinate Timing
Managing Yourself - Interviewing

**Agenda**
- Organizes multiple topic areas
- Introduces multiple interviewers/participants
- Highlights progress of interview
- Helps keep all parties on track

Interview Management (cont.)

What is good and bad in this picture?
Interview Management (cont.)

- Good – conducted in the auditee’s office (comfort zone)
- Bad – Sit at a conference table (no barriers)

Interviewing Techniques

- Never be Late
- Stay within the Allotted Time
- Stick to Relevant Questions
- Move from Simple to Complex
- Establish Rapport
  - Professionalism
  - Commonalities
  - Familiarity
Interview Management (cont.)

- Establish Rapport with the Interviewee
  - Mutual trust and understanding; not good buddies
  - Don’t be a rat
  - Follow business norms
  - Eye contact, handshake
  - Small talk is just that – A little bit is just enough

Blocking Time

- Maximized productivity and efficiency
- Schedule durations based on level:
  - 1 or 2 hours for advisors/middle managers
  - 1 hour for line/staff workers
  - Will be many exceptions
Maintaining Control of the Interview

- Efficiency and Effectiveness is Key!
- Control the Interview (if possible)
- Fix the Environment – make as comfortable as possible
- Control Disruptions
- Control Yourself – Keep the interview focused on the objectives
- Keep the interviewee focused and moving forward
- Ask Questions for Clarification (Active Listening)

Interview Variations

- Group Interviews
  - Maximize results; minimize time and effort
  - Watch for GroupThink!
  - Use when results are expected to be similar from the group.
  - Limit groups to 4-8 interviewees (like pre-K; 4-6 kids per teacher)
- Advanced-Question Interviews
  - Use when no contentious information
  - Early planning stages; gather as much background as possible.
Interview Variations

- Telephone Interviews
  - Short interviews
  - Noncontroversial interviews (no contentious information)
  - Repetitive Interviews (similar questions to lay foundation, familiarity with interviewee and subject matter)
  - Plan the same as an in-person interview
  - Make sure there are no distractions in front of you.
  - Utilize active listening

Recording the Interview

- There is no such thing as “off the record”
- Do not tape record conversations
  - Take short hand notes
  - Have someone leading the interview and one taking notes
- Follow up on Your Interview
  - Record action items and follow through with them
  - Document results
  - Document interview as soon as possible
  - Send documented interview back to interviewee for confirmation
Ending the Interview

- End on a positive, upbeat note.
- If you need more time, reschedule at the earliest possible date.
- No matter if the interviewee continues to talk over the allotted time, show respect for their time and make sure to ask if they would like to end the interview now or continue forward.
- Allot 30 minutes – 1 hour between interviews
- Be thankful and appreciative
- Send a follow-up summary email
- Close early if you are not getting the information you need.
Professional Skepticism

Trust but Verify

Professional Skepticism – Questions to Ponder

- Is the statement reasonable?
- Is the interview as a whole internally consistent?
- Are there exceptions?
- Can I verify it?
- Any whiff of fraud, waste or abuse in what was just said?
- Is the interviewee credible? Was the offered support credible?
- Does the interviewee have any reason to lie?
- Any reason to suspect bias?
Documenting the Interview

- Things to Include:
  - Who
  - Title
  - Contact Information
  - Where and When
  - Why (TIE to objectives)

Info Needed on Every Interview Document

- Any leads your interviewee might have given
- All trails that should be followed as a result of this interview
- All corroborating evidence is cross-referenced.
- Specifics, such as:
  - Correctly spelled names, positions, and employer/department/office of interviewee and all who are present;
  - Date, time place of interview;
  - Interview style (in-person vs. phone)
  - Reason interviewed
Documenting the Interview

- Common pitfalls
  - Too much detail
  - Clarity as to whose statements are documented (interviewee’s or auditor’s)
  - Obvious follow-up questions are not asked
  - Unresponsive or contradictory answer go unchallenged – or unrecorded.

Documenting the Interview

- Corroboration
  - Whenever possible, get documentation of assertions of important facts
    - Dates
    - Events
    - Statements
Documenting Your Interview

- Interview Transcripts
  - Full written account of an interview
  - Word for Word account of every discussion throughout the interview.
  - Chronology of events
- DO NOT RECOMMEND!

Documenting Your Interview

- Interview Recaps
  - Narrative accounts of interviews.
  - Not verbatim but recount the main thrusts or interviews.
    1. Sort relevant vs. irrelevant information in separate sections. If you do not need it, discard it.
    2. Sort and group relevant information according to general subjects and write an overview sentence/paragraph that summarises the discussion.
    3. Describe the interview deductively: introduction, details, conclusions.
    4. Note all pertinent observations and impressions of the interview, interviewee and answers.
Documenting Your Interview

- **Interview Summaries**
  - Synopsize the main relevant information obtained from interviews.
  - Appropriate for short interviews that produce few details and are unlikely to be contested.
  - Summaries are very useful for workpapers
    1. Look through your transcript or notes for the most encompassing information related to your audit objective. Summarize in one sentence.
    2. Include enough details to enable readers to reach the same conclusions
    3. Present conclusion regarding information obtained from interview.
    4. Focus on the audit and interview objective and answers to them.

How to Sort Through Interview Results

- What is the real value we can provide?
- What is Real versus what is Personal (BIAS)?
- Keep in Mind – Respondents need to Impress!
- Document the Interview
- Professional Skepticism
Analyzing Interview Results

- Look for Value
- Analyze Step by Step
  - Logical approach based on the nature of the information and relationship between answers
- Key Factor:
  - Identify the key factor that ties all of the information you obtained from the interview to your audit objectives.
    - Does it support or deny the audit objectives and hypothesis?
- Reliability
  - Pay close attention to the unique advantages and disadvantages of testimonial evidence when analyzing interviews.
  - Very reliable/marginally reliable and some is unreliable.
  - Can be tainted by attitudes, biases and protection of self/peers/organization.
- Synopsis:
  - By overall theme, details, conclusion

Separate the Information
- Separate facts, opinions, beliefs, misconceptions, and conclusions from one another.
- Facts are verifiable with other evidence; opinions, beliefs, misconceptions and conclusions can be proved or disproved through logical analyses, but they are not verifiable with other evidence. Misconceptions can be held as if they were true; they are not lies.

Use Finding Elements:
- Determine which were found in the interview (criteria, condition, cause, effect).

Isolate the Irrelevant
Analyzing Interview Results

- Evaluate Quality
  - Compare between interviewee’s
  - Look for contradictions, inconsistencies, loose ends.
- Compare to Expectations
- Draw Conclusions
Study of what is good and evil, right and wrong (based on societal norms), just and unjust

Ethical dilemmas can be obvious to some and oblivious to others

Ethics are viewed differently by age, background and value system
Study of what is good and evil, right and wrong (based on societal norms), just and unjust in an organization.

Comprised of the principles and standards that guide behavior in the world of business.

Determined by key stakeholders in an organization or, to an extent, rules and regulations (government agencies, public companies).
Examples of Ethical Dilemmas

- Individual values and the company
  - Receiving or offering kickbacks
  - Stealing from the company
  - Questionable business expenses (T&E)
  - Confidential information/trade secrets
  - Utilizing company property for personal use
  - Conflict of interest

Examples of Ethical Dilemmas (cont.)

- The Company and Individual Rights
  - Whistle-blower fired
  - Employee screening vs. privacy
  - Sexual harassment
  - Affirmative action
  - Employee rights
  - Due process
Examples of Ethical Dilemmas (cont.)

- Business Operations
  - Workplace safety
  - Business environment and practices in other countries (pay-offs, etc.)
  - Procedures (financial, cash management)
  - Environment issues

Legalization of Business Ethics

- Federal Sentencing Guidelines for Organizations (FSGO)
  - Standards and procedures (code of ethics)
  - High level oversight
  - Care in delegation of authority
  - Effective communication (training)
  - Systems to monitor, audit and report
  - Consistent enforcement
  - Continuous improvement
Key Causes of Unethical Behavior

- Meeting overly aggressive financial or business objectives ("meeting earnings expectations")
- Meeting schedule pressures ("it has to be done today no matter what")
- Helping the organization survive ("staying out of bankruptcy by falsifying earnings, etc.")
- Others do it so I can too (charging through alcohol or expensive meals outside of policy guidelines)
- Saving jobs

Key Influences on Ethical Behavior

- How you grow up
- Personal moral and values
- Influence of meaningful people (mentors) – supervisors, parents, family, etc.
- Influence of senior management
- Personal drive
- Performance pressures
- Lack of consequences
- Law
Other Determinants of Ethical Behavior

- Religious convictions
  - Reciprocity
  - Fairness
  - Charity
  - Responsibility
- Moral philosophy
- Ethical philosophy

The Justification Dynamic

- Everybody else does it
- If I do not do it, someone else will
- It is the way it's always been done
- Let's wait until someone tells us it is wrong
  - Legality has nothing to do with ethical behavior
- We are not hurting anyone
- The system is unfair
Ethical Issue Types

- Conflict of interest
- Do one to others.....
- Communication
- Organizational relationships

Conflict of Interest

- Exists when an individual must choose whether to advance his/her own interests, the organization’s, or others’
  - Examples include bribes or personal
- Payments, gifts, or special favors intended to influence decision making
Do One to Others.....

- Treat all with honest and fairness
- Following applicable laws and regulations & not knowingly harming stakeholders
  - Is advertising prescription drugs on TV and in magazines fair?

Communications

- Transmission of information and the sharing of meaning
  - Examples: deceptive advertising, product safety information, & product composition
Organizational Relationships

- Behavior of organizational members toward stakeholders
  - Includes confidentiality, meeting obligations & deadlines, not pressuring others to behave unethically

Why Should We Be Concerned With Ethics?

- Laws can be viewed as insufficient and do not cover all aspects or gray areas of a problem
- Free-market and regulated-market mechanisms do not effectively inform owners and managers about how to respond to complex crises
- Cost/benefit
- Whatever come around, goes around
Discussion – What is the Cost of Unethical Behavior?

Complex Ethical Decisions
Us Versus Them

- A customer asked for a product from us today. After telling him our price, he said he could not afford it. I know he could get it cheaper from a competitor. Should I tell him about the competitor -- or let him go without getting what he needs? What should I do?"

Minority Report

- Our company prides itself on hiring minorities. One Hispanic candidate fully fits the job requirements for our open position. We are concerned that our customers will not understand his limited command of the English language. What should I do?
To RIF or not to RIF

My boss told me that one of my employees is among several others to be laid off soon, and that I’m not to tell my employee yet or he might tell the whole organization which would soon be in an uproar. Meanwhile, I heard from my employee that he plans to buy a new house. What should I do?

Personal Versus Business

My computer operator told me he’d noticed several personal letters printed from a computer that I was responsible to manage. While we had no specific policies then against personal use of company facilities, I was concerned. I approached the letter writer to discuss the situation. She told me she had written the letters on her own time to practice using our word processor. What should I do?
Famous Ethical Dilemmas

ZZZ Best = Self-Preservation

- Carpet Cleaning Business
- Barry Minkow
- Went public
  - Check kiting
  - Stealing
  - Staging break-ins at his offices
  - Running up fraudulent credit card charges
  - Ponzi Scheme – Insurance Restoration Business
Enron

- One of the major scandals that lead to the Sarbanes-Oxley Act of 2002
- Ken Lay, Jeffrey Skilling, Andrew Fastow
- Offshore entities
  - Tax avoidance
  - Hidden losses
- Selling Enron stock
- Mark to Market

AIG

- Liquidity crisis – credit ratings downgraded below AA levels in September 2008
- AIG had valued its Alt-A and sub-prime mortgage-backed securities at 1.7 to 2 times the values used by Lehman which weakened investors’ confidence in AIG
- Received Federal bail out funds (TARP)
- Lavish spending after bailout
Bernie Madoff

- Ponzi scheme
- Sentenced to 150 years in prison with restitution of $170 billion
- Approximately $65 billion fraud
- Paid legal kickbacks
  - Paid a broker to execute a customer’s order through his brokerage
  - Reputation of being the largest dealer in NYSE-listed stocks in the U.S., trading about 15% of transaction volume

Lehman Brothers

- Largest bankruptcy in US history
- Subprime Mortgage Process
- March 2010 Report (court-appointed examiner)
  - Lehman executives regularly used cosmetic accounting gimmicks at the end of each quarter to make its finances appear less shaky than they really were (repurchase agreements)
  - temporarily removed securities from the company’s balance sheet
- Used an accounting procedure termed repo 105 to temporarily exchange $50 billion of assets into cash just before publishing its financial statements
Discussion – What are the Ethical Dilemmas from the Examples Above?

What is the Ethical Dilemma?

- Greed
- Excessive spending
- Lack of a strong moral code
- Broke the Golden Rule
1. The Golden Rule

- Do one to others as you would want others to do to you
  - Treat all work situations the same as you would a personal situation
  - Do you normally fly first class?
  - Do you normally go to a first class steak house when out of town?
2. The Right Questions

- Are you confident that your position will be as valid over a long period of time as it seem now?
- Could you disclose without qualm your decision or action to your boss, your CEO, the board of directors, your family, society as a whole?
- Would you feel comfortable discussing via subpoena?
- How would you feel if the issues was in the newspaper?

3. Perception Can Be Reality

- How is the situation perceived by peers?
  - Does not matter reality; it is how it is spun and perceived.
- Logic Test
  - Does this make sense?
- Do not over think the situation
  - Simplify
4. Do What Feels Right

- Not what feels good but right
- If you would be embarrassed by it, you should not do it
- You know in your heart what should be done

Ethics is Personal

- If you are unsure if it’s a problem, it usually is.
- *Ethics will always be important, especially in these trying economic times, which is driving survival and greed.*
- Use common sense; if it does not feel right, it probably is not right.