Chapter 1

Definition, Characteristics, and Guidance

Be a Product of the Product

What does it mean to be a product of the product? It's quite simple. Be a living example of what you sell, recommend or advise others. Personify what you preach. Show don't tell. Lead by example.[1]

John B. Petersen III

Introduction

Internal audit is undergoing a massive transformation. While its role to provide independent, objective assurance and consulting services to organizations in ways that improve their operations has remained constant for decades and remains true today, how this has been accomplished has changed over time.

Since the founding of the Institute of Internal Auditors (IIA) in 1941, the profession has evolved to adapt its personality, purpose, and approach to the changes taking place in the fields of management and organizational behavior. Universities and other academic institutions capitalized on the lessons of the industrial era and developed organization theories that created systems whereby centralization, a defined hierarchy, distinct authority levels and reporting lines, clear rules, and the division of labor were the norm.

Internal audit adapted to this approach and adopted it, so its methodologies were consistent with these theories. Standardization was the norm and organizations implemented rigid guidelines for how they functioned. Consequently, internal auditors did the same and implemented standardized approaches to audit their clients in those organizations. This search for consistency resulted in the proliferation of checklists, standard audit programs, and procedures. In the end, internal auditing evolved in a way that validated the organizations' hierarchy and structure, its centralization, assignment of rigid authority, discipline, rules, and the division of labor procedures against the standard model. The audit function, then, focused on assessing an organization's control or operational effectiveness with this standardization and could do so quickly by using

checklists, prepared questionnaires, and reviewing the same documents year after year to verify consistency.

There was, and for those who continue to audit this way, a concealed risk. The focus on standardization limited the auditor's ability to be creative. Creative thinkers were not sought for nor gravitated toward the profession. Using the excuse, and the legitimate need for independence, internal auditors isolated themselves from the businesses they examined and were supposed to support. Some even abstained from making recommendations to improve the weaknesses they identified. This risk became apparent in the 1960s and lasted through the 1980s.

While internal auditors were protecting their independence, the businesses they served were changing due to globalization, technological advancements, relentless competition, and a new social, demographic, and financial landscape. Companies no longer operated using the standard model. Since manufacturing moved to different countries, it was impractical to have a single procurement function with a single manager overseeing all purchasing activities. Since customers were now located around the world, the approval of customer orders could no longer be handled expeditiously and competently by the sales manager. Purchasing and sales decisions were now being made by regional general managers at the countries where these activities took place. Approving and making adjustments to customer accounts, were no longer handled manually and personally by the company's controller. There was no need to. The local staff could handle that under the supervision of their local management team. The company's enterprise resource planning (ERP) system provided the necessary separation of duties and limited transaction processing to those authorized.

Many internal auditors missed these changes and were slow to adapt to the changing landscape, instead believing that the world still operated by the standard business model. The result? Many became irrelevant. Some internal auditors still used their standard checklists, asked the same questions, searched for the same documents, and applied the rules of the standard business model. They continued to insist that outdated procedures be followed, like having the sales vice president approve all customer orders and the corporate controller print out the credit memos and sign them.

There was little disagreement about the need for effective internal auditing. Broad consensus existed about the importance of having a strong and reliable internal control environment. Generally, management believed in the importance of having sound internal controls, but did not believe that the internal audit function was making an effective contribution to the company. Boards of directors and their management teams slowly lost confidence in an internal audit function that focused so disproportionately, and inflexibly, on traditional business models that they recommended changes to the business that were clearly out of step with how the company needed to function. The disproportionate focus on compliance led many auditors to focus on what they thought was important to the business and less on what was truly important to the business. Management became disenchanted with auditors who wanted to refrain from making changes, even when the internal and external environments demanded quick and judicious modifications to the business structure and its practices. Beyond the methodology, some managers even wondered why some audits were being performed in the first place.

As if that weren't enough, there was another problem. Internal audit in many ways evolved as an offshoot of external audit (i.e., public accounting) and excessively replicated external auditing by focusing on accounting transactions and the process of preparing financial statements. While the focus was generally more detailed and the materiality thresholds used by internal auditors was much lower, reviewing and reperforming accounting procedures seemed wasteful if the organization was already paying their external auditors to audit the accounting practices that led to the publishing of the company's financial reports.

Much has changed since then. Starting in the early 1990s, internal audit began a transformation process that is bringing it more in line with the true needs of the organizations it serves and the related stakeholders. The emergence of the stakeholder theory and topics about corporate governance, quality, and cycle time, in addition to the constant advocacy work of the IIA have brought many changes to the profession. The dot com meltdown in 2000/2001 and the enactment of the Sarbanes–Oxley Act of 2002 were wake up calls for the profession.

Today internal audit is achieving a healthier balance among operational, reporting, compliance, information technology (IT), fraud, and strategic topics. It is now looking beyond the immediate fiscal year and taking a closer look at longer term trends and the future implications of current dynamics. It is now identifying a wider set of essential skills, and finding that to succeed as a trusted advisor to the board and management, it must bring into its ranks people with a wider skillset, including broad business skills, strong communication skills, and familiarity with technology.

But there is still work to be done. The State of Internal Audit 2013 report from Thomson Reuters Accelus states that although internal auditors are beginning to evaluate more strategic-level risk management and monitoring activities, most internal audit departments continue to focus primarily on process assurance and monitoring activities. Respondents to the survey indicated there is a lack of skilled resources due to the changing role of internal auditors away from traditional quantitative assessments and toward becoming a qualitative assessor of the organization's goals and strengths. This condition remains true as this book goes to print. In this book, we discuss these dynamics and lay the foundation for effective operational audits.

We begin by defining and understanding the definition, role, and practices of modern internal auditing in general and the evolving world of operational auditing in particular. We examine the concept and manifestation of organizational risks and how internal auditors must adopt a risk-based auditing approach, which will allow it to better support the objectives of the organization.

Integrated auditing is a concept that has been in place for decades, yet many internal auditors still struggle to practice it effectively. We discuss key attributes of effective integrated audits and why it is essential for effective operational audits.

We end this chapter with a review of selected Standards for the Professional Practice of Internal Auditing (the *Standards*). But more than list them, we discuss their implications in the broader topic of operational auditing, and how these standards can be applied successfully.

Definition and Characteristics of Operational Auditing

Operational auditing is defined as "A future-oriented, systematic, and independent evaluation of organizational activities. Financial data may be used, but the primary sources of evidence are the operational policies and achievements related to organizational objectives. Internal controls and efficiencies may be evaluated during this type of review."[2]

The Business Dictionary defines operational audit as "A review of how an organization's management and its operating procedures are functioning with respect to their effectiveness and efficiency in meeting stated objectives. For example, a business might perform an operational audit if its senior management has become convinced that operational improvements can be made and need to be identified."[3]

I worked in banking operations for 6 years after graduating from college. Over time, one of my roles involved working with the marketing and IT departments to bring new product concepts to market and ensure their smooth implementation and operation. The work involved managing

account creation and servicing of loan programs from account setup to payoff. There was a great deal of paper involved and the work was tedious, time consuming, and often stressful.

Due to the growth of the organization, the large volume of paper files and the related logistical difficulties of finding files at various stages of processing and storing documents, and manually reviewing each file to ascertain its credit worthiness, the company embarked on a reengineering project. I was invited to participate as a business partner during the reengineering and restructuring project and I gladly accepted the offer. The result was several months documenting existing processes while brainstorming how to make the processes faster, cheaper, and better for all involved.

We hired an external consulting firm and as I split my time between my regular work and the sessions with the consultants, I got an education on brainstorming, documentation, meeting facilitation, collaboration, negotiation, flowcharting, and time management, among many others. In the end, we successfully introduced a credit scoring system that reduced the amount of time and the number of people needed to process loan applications, we replaced paper records with scanned images for document safekeeping and underwriter review, and were able to provide faster and more accurate status updates about the loan application process and related disbursements.

I leveraged this experience when I subsequently left the bank to work as a business analyst in the insurance industry. For 2 years, I documented business requirements for software engineers, tested systems before rollout, and helped train end users. This involved facilitating workshops to define business requirements and system specifications, performing process design, mapping and analysis, and creating training materials. My role also involved writing client acceptance test procedures to verify that all requirements were included in the design. This experience taught me the intricacies of interviewing and working closely with computer programmers and operations personnel, facilitating meetings, documenting system layout and functionality, and training users. It also helped me to gain a more in-depth understanding of the nature of internal controls at various levels of system design, assessing the significance of system flaws, and postrelease reporting requirements.

My third career move was more directly related to my original career aspiration: work in international business. I wanted to take advantage of my professional experience, diverse personal background, and multiple language skills, so I contacted the internal audit department and asked for an informational interview. The internal audit manager who interviewed me asked many questions and appeared to be more interested in my experience documenting, analyzing, and improving business processes, than my degree in finance.

During our interview, we spoke about the importance of asking "who," "what," "when," "where," and "how" regarding the activities performed within a process, the people working within that process, and the systems supporting both the people and the process. One aspect of the conversation that still resonates with me was how animated she became when we discussed the importance of asking "why." While "who," "what," "when," "where," and "how" provide very valuable information to *describe* the process and understand how the process behaves, "why" provides even more valuable information because it pertains to the *purpose* of the activities performed.

As I knew then, and have come to observe repeatedly over the years, there are countless individuals in organizations working feverishly on activities with an unclear or undefined purpose. In some extreme cases, they perform activities that lack any purpose whatsoever, but they continue performing those activities "because we have always done things that way."

The interview was very productive and successful and I was offered a job within a few days. I promptly accepted the offer and so began my career working on the international team of a company that was rapidly expanding in Latin America. I became an internal auditor.

My relatives, friends, and business acquaintances were very supportive of my career decision, and I was very happy for their support. What I was not expecting, however, was the general lack of awareness about internal auditing as a profession, and what internal auditors did in particular. Some of their first words often became a statement along the lines of

> "Oh, so you are going to work for an accounting firm?," or
> "I didn't know you wanted to work for the IRS!," or the question
> "Did you major in accounting?" or something along those lines.

Essentially, in the mid-1990s, internal auditing was generally unknown, and for those with some inkling about the profession, the tendency was to associate it with accounting, compliance, and tax-related work.

There was a general lack of awareness and while I was learning about internal auditing too, I knew that internal auditors did more than accounting, compliance, and tax work. I took the opportunity to explain as best I could the expanding role of internal auditors and how they helped management at multiple levels. I was doing my own advocacy work explaining the work of auditors in general and the exciting opportunities that this presented for me.

Since those days, the IIA has done an impressive job raising awareness through advocacy about internal auditing.[4] This effort was enhanced through the formidable work done by Cynthia Cooper, who with her staff unraveled the massive fraud at WorldCom; Sherron Watkins, who was instrumental in alerting others of the accounting irregularities in financial reporting at Enron; and Coleen Rowley, who documented the mishandling of information and failure to take appropriate action at the Federal Bureau of Investigation (FBI). In fact, their work was so instrumental in uncovering these problems, that they jointly received the *Time* Person of the Year award in 2002 as The Whistleblowers.[5]

As we take a closer look at internal auditing, it is helpful to review the definition of internal auditing as promulgated by the IIA. According to the IIA, the definition of internal auditing "states the fundamental purpose, nature, and scope of internal auditing"[6]

> 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.

Although this definition has been in place for years, it is still misunderstood by many nonauditors, and unfortunately, even by some internal auditors. The misunderstanding stems from a variety of reasons and heavily influenced by the legacy of auditors performing financial reviews and internal auditors having accounting backgrounds.

The definition reflects a modern view of the profession and positions auditors in such a way that they can provide much more valuable assistance to their organizations. The definition creates a variety of challenges and opportunities for internal auditors, who are no longer engaged in a static, routine, repetitive, and accounting/finance-focused activity, but instead admonishes internal auditors to review business programs, processes, and initiatives in innovative ways that can add tangible value to the organization.

The definition contains some key language that is important to note:

1. *Independence* has to do primarily with the position of internal audit within the organization's hierarchy. Internal audit should report to the audit committee (or its equivalent) on the board of directors so it receives advice and support to perform its duties. Furthermore, internal audit should not be under the control of those they audit. This direct reporting line to the highest authority within the organization will help internal audit reach its full potential, and also get the attention from those whose influence, recognition, and respect can compel corrective action of any anomalies identified by the auditors.
2. *Objectivity* is related to the auditors' frame of mind and their ability to examine documents, processes, and programs without a bias, without an agenda, with no other motive than to find the truth and communicate it accurately and promptly. Conflicts of interest are one of the biggest threats to objectivity, so internal auditors must be careful to balance maintaining healthy professional and social relationships with others in the organization without becoming too cozy with them.
3. *Assurance* relates to the auditors' ability to give confidence and make statements regarding the condition of matters within the organization. It is often considered a synonym to "compliance" as has been the traditional focus of internal auditors for millennia. Compliance audits focus on verifying conformity and adherence of a particular area, process, or system with policies, plans, procedures, laws, regulations, contracts, or other requirements that govern the conduct and actions of that area, process, or system.

Internal auditors provide reasonable assurance, not absolute assurance, because there are numerous variables to contend with constantly, but also because there are no certainties in life. However, this does not mean that internal auditors do substandard work knowing that they can't guarantee results. Internal auditors are expected to display competence, knowledge, and act with due professional care in all they do to provide the best assurance possible. Compliance can be driven by requirements that are internal or external, regulatory or not, explicit or implied.

I mention implicit, because the subject of corporate social responsibility (CSR), humane working conditions, and lower ecological impact is not always formally codified, but stakeholders are increasingly demanding compliance with higher ethical and moral standards of conduct. In fact, the Value of Sustainability Reporting study from the Boston College Center for Corporate Citizenship and EY (Ernst & Young) states that 68% of the 579 global organizations surveyed make a sustainability disclosure annually. Sustainability reports are becoming a leading business practice for large organizations worldwide.

There is increasing interest among organizations and investors in these types of reports as a way to make sure that environmental and social impacts are managed and as a way to assess the quality and commitment of management to economic, environmental, social, and governance topics. According to the report, there are four main reasons why organizations report:

a. Provide shareholders more transparency
b. Gain competitive advantage
c. Improve risk management capabilities
d. Respond to stakeholder pressure

The word "stakeholder" is a broad term used to denote any person or group that affects, or is affected by, an organization's policies, decisions, and actions. Stakeholders may be voluntary or involuntary, and either bear risks or share benefits. Since there is a strong, and ever more intertwined relationship between organizations and the environment in which they operate, there are shared interests and an interdependence that develops between any organization and other groups. Making sure that there is fair treatment and consistent, universal adherence to established social regulations are key objectives of compliance reviews.

Sustainability reports can be issued in accordance with the Global Reporting Initiative Guidelines[7] or another standard. Although it requires a great deal of work, the report indicates that the financial and social advantages outweigh the costs. In fact, half of the respondents indicated that sustainability reporting gave them a competitive advantage, so it implies that organizations should assess their sustainability practices and that these should inform corporate strategy.

CSR should function as a built-in, self-regulating mechanism enabling organizations to monitor and ensure compliance with laws, ethical standards, and international norms. The expectation is that CSR is deliberately included, and there is consideration of the public interest into corporate decision making. Organizations are expected to honor the triple bottom line: people (social), planet (environment/ecology), and profit (economic).

Since there are assurance implications involved, survey respondents indicated there are challenges too. These include availability of data, accuracy and completeness of data, and internal buy-in.

4. *Consulting* means giving advice to management and the board, and engaging in activities that helps the organization resolve nagging business issues. These engagements address performance, how to improve organizational programs, processes, and activities, and how to become more flexible, nimble, and responsive to business challenges. It also relates to the special projects that internal auditors sometimes work on. Lastly, consulting also relates to the way auditors do their work suggesting that the traditional mindset and role of the auditor as the corporate cop is being redefined and replaced by a more business-minded professional whose goal is to be respected more so than being feared.
5. *Designed to add value*. If you ask a gathering of internal auditors if they add value in their organizations, they unanimously raise their hands in agreement. If you pose the same question to nonauditors, the response is often far less enthusiastic. In fact, some may even argue that internal auditors are a necessary evil and an expense they can't do without because regulations, the board of directors, or other stakeholders demand the existence of an internal audit function. One of the goals of this book is to show how this goal of adding value can be achieved, and do so convincingly.
6. *Improve an organization's operations* is a very interesting statement because many auditors see their role as that of checking things and verifying the accuracy of various items and activities within the organization. But improve an organization's operations? Some would argue that this is a rather broad subject, a tall order, a complex goal, a challenging aspiration, and an insurmountable target. I believe it is not only achievable, but also expected of modern internal auditors.

   Over the years, internal auditors have made many positive contributions to their organizations, but in some cases, they have become part of a problem: creating bureaucracy within organizations by recommending a never ending list of controls to mitigate risks, some of which are miniscule in their theoretical assessment and smaller yet if they were to materialize. Some audit teams operate under the mindset that they have to find something so they can produce a report, which inevitably will result in a series of recommendations for additional control procedures. In this book, we will examine ways in which internal auditors can help to improve operations to enhance efficiency,

effectiveness, speed, and yes, reduce errors. By doing this, we will be better prepared to address business risks.

7. *Help an organization accomplish its objectives.* Many auditors practice what has been commonly referred to as controls-based auditing. In essence, they look for the controls within the process or program of their review, then check them to see if they are present and operating as expected. While this is important, they often forget to link those controls to the relevant risks, and link these risks to the business objectives that those risks threaten. All of this to say that the starting point for everything auditors do should be the identification of the relevant business objectives. With that in mind, then, internal auditors must do their work in ways that help the organization achieve its objectives by properly responding to the risks that threaten these objectives. By focusing on this, internal auditors can add value and the possibilities are almost endless.
   During my early years in internal audit, one of my audit managers told me: "Think of yourself as running this department. Now, how would you then run it so it is successful?" With this in mind, I was told to prepare the audit program that would guide me and my team's work checking on the elements that should be there to improve their likelihood of success, and the roadblocks that could get in their way. Very wise words!
8. *By bringing a systematic, disciplined approach.* This refers to the approach followed when performing the work. This is encapsulated in the *Standards*, the Practice Guides and Practice Advisories, which provide a great deal of guidance on how to plan, execute, and communicate the results of the work done. Our methodology is quite extensive, and it provides enough direction and flexibility as a framework to examine virtually any aspect of an organization's operations.
9. *To evaluate and improve the effectiveness.* Our role as auditors goes beyond evaluating business dynamics and writing reports that merely lists the problems identified. The definition indicates that we evaluate, but also help to improve the organization's ability to achieve the goals and objectives related to:

   a. *Risk management.* This refers to the identification, measurement, assessment, and response to risks.
   b. *Control.* This refers to those activities that mitigate relevant risks and helps the organization avoid surprises.
   c. *Governance processes.* Corporate governance is a wide subject that includes matters related to organizational structure, reporting lines, span of control, resource allocation, accountability measures, discipline, and rewards mechanisms. Corporate governance relates to ethical behavior by directors and others charged with the creation and preservation of wealth for all stakeholders. The IIA's Position Paper on Organizational Governance states that since internal auditors are tasked with providing assurance on the risk management, control, and governance processes of their clients, they are one of the cornerstones of effective organizational governance. Auditors provide independent, objective assessments on the appropriateness of the organization's governance structures and the operating effectiveness of specific governance activities. They are catalysts for change, advising, or advocating improvements to enhance the organization's governance structure and practices.[8]

In my experience as an auditor, trainer, and consultant, I still find that too many auditors practice the traditional form of auditing that can be described as tick and tie. Another way to describe it is adding rows and columns on spreadsheets and reports to verify their mathematical

accuracy. While this is important to verify accuracy and completeness, modern internal auditing is far more complex and while it presents numerous challenges due to its very expansive nature, it also provides countless opportunities to add value in new and innovative ways, also for internal auditors to demonstrate their abilities.

Internal auditors often have college degrees and many also possess master's degrees. They often have professional certifications ranging from Certified Public Accountant (CPA), Certified Internal Auditor, Certified Information Systems Auditor, and Certified Fraud Examiner (CFE), among many others. They typically have many years of experience and have a great deal of knowledge to tap into as they examine business activities. The new role of internal audit provides many opportunities to leverage this knowledge and experience for the betterment of their organizations.

By focusing on what I consider the "other parts of the definition," internal auditors would find that they can expand and enhance their work in ways that would create a much more positive and rewarding experience with management. Furthermore, it makes for a more exciting experience as auditors would not be limited by old practices and would have the freedom and flexibility to evaluate business risks in innovative ways.

After comparing the two definitions, operational auditing and internal auditing are indeed quite similar!

The Other Parts of the Definition

While many people focus on the accounting and compliance aspects of internal auditing, the definition mentions other aspects of the trade that are not as widely embraced and practiced by auditors. By this, I mean words like "consulting," which speaks more literally to the special projects that internal auditors sometimes embark on. While the definition refers to "assurance," which refers to traditional compliance work, I believe consulting refers to more than just special projects. It also includes the way auditors do their work.

I have found that by not only thinking of consulting as special projects, but also thinking in terms of the auditors' attitude, disposition, frame of mind, and working practices, it would go a long way toward living the intentions of "and consulting activity." For example, many internal auditors focus on one-on-one interviews and scantily practice facilitated sessions, where you bring together several employees for discussion, fact finding, problem identification, brainstorming solutions, and prioritizing alternatives. Another example is not being so afraid of scope creep that auditors fail to examine the root causes of business issues sufficiently. In this book, I present numerous tips, tools, and techniques to improve the interaction with audit clients and root cause analysis, among other critical activities.

Another aspect of the definition is "… improve an organization's operations." To me these words speak volumes about the importance of not only checking processes to make sure that control activities are performed according to procedures documentation, but also looking at the risk of bottlenecks, slowdowns, rework, and other operational dysfunctions that are the result of what I consider "the other types of risks." Internal auditors have focused disproportionately on accounting and financial risks, the risk of poor recordkeeping and classification, financial abuse, and theft. But many organizations thrive or fail based on their ability to manage the risk of inefficiency, ineffectiveness, rework, and delays better than the competition. The importance of managing these dynamics does not escape the nonprofit sector, as many NGOs, academic, and government institutions are increasingly operating with reduced budgets while struggling to achieve their mission and objectives.

So what is operational auditing?[9]

Operational auditing is a future-oriented, independent, systematic, and business-focused evaluation of management, and the organization's activities controlled by management and third parties. This is done to benefit the organization's stakeholders who trust internal auditors to identify anomalies, verify that resources are handled responsibly, and that the organization is structured and operating in ways that it is likely to succeed.

The purpose of operational auditing is to improve organizational profitability and the attainment of organizational objectives. These go beyond a review of internal control issues since management does not achieve its objectives simply by adhering to satisfactory systems of internal control. Instead, management must define its goals, set appropriate strategies, staff the organization with enough and competent workers, and execute effectively.

Operational auditing also involves evaluating management's performance, since they have a fiduciary responsibility toward the organization's owners and other relevant stakeholders. Over the past few decades, the expectations of stakeholders have increased monumentally creating a more challenging environment for managers and auditors alike. These expectations range from CSR, to acting ethically, safeguarding key information, and maintaining a positive reputation.

Another important aspect of operational auditing is that rather than merely verifying that employees are performing their duties according to established policies and procedures, internal auditors also verify a variety of qualitative aspects of the organization and its activities. Regarding procedures documentation, internal auditors are expected to verify that these documents are up to date, that they are relevant, that they reflect the best way to perform the work with regards to efficiency and effectiveness, that these documents are safe from unauthorized change, they are understood by employees, and that their location is known by employees so they can refer to them for guidance when there are questions.

Operational audits may also be concerned with the structure of the organization, since a poorly structured organization, or one where information does not flow accurately and promptly jeopardizes efforts to achieve objectives. Instead, poorly structured organizations tend to be disorganized, inefficient, have high employee, customer, and vendor turnover, and become wasteful. All of these manifestations of dysfunction erode the ingredients for success and an auditor who brings a fresh and objective perspective to the review can identify these weaknesses.

In the end, operational auditing is designed to evaluate the effectiveness and efficiency of business activities, processes, programs, functions, and units. The scope may be different from traditional fiscal-year scope periods, since achieving these objectives may require an analysis of multiple time periods to identify, analyze, and understand trends, patterns, outliers, and other positive or negative dynamics of interest.

These other risks are of importance to internal auditors, since our definition indicates that we are responsible for risk management, as stated in Standards 2010 (Planning), 2100 (Nature of Work), and especially 2120 (Risk Management).

The Risk-Based Audit

Engaging in risk-based auditing means that internal auditors must exercise and apply a broader view of organizational risks. Accounting and financial risks are only a limited number of the many risks organizations face. Other examples include the risk of delays, waste, inefficiency, poor customer service, excessive customer and employee turnover, poor quality data, and system failures. Although these risks actually characterize the working environments in many

organizations, and affected employees readily describe the impact these risks have on profitability and the organization's ability to succeed, many auditors fail to identify, measure, and assess sufficiently the mechanisms in place to mitigate those risks.

Some organizations have come a long way in their attempts to correct this deficiency, such as hiring auditors with more diverse backgrounds. Over the past decade, I have met many auditors with diverse academic and professional backgrounds, such as engineering, nursing, geology, and biology degrees and backgrounds, among others. While hiring auditors without auditing experience poses some training challenges, it helps to bring into the unit a diversity of skills and mindsets that enriches the department and provides valuable insights into other risks affecting the organization. Furthermore, the drive to achieve diversity provides a competitive edge for the profession as we broaden our recruitment efforts and thrive to make sure that every auditor individually, and internal audit departments collectively, possess the knowledge and proficiency to perform their duties.

While traditionalists may find this expansion of auditor backgrounds puzzling, it is consistent with the guidance provided by the IIA. The IIA is the governing body of internal auditors worldwide. Founded in 1941, it counts more than 180,000 members in 180 countries[10] and has issued guidance for internal auditors in the form of the Standards for the Professional Practice of Internal Auditing (the *Standards*), Practice Advisories, Practice Guides, and Position Papers. These documents provide guidance on what internal auditors should do, and how.[11]

This concept of risk-based auditing is in contrast to what has been dubbed controls-based auditing. The latter is defined as audits that focus on identifying and evaluating internal controls without enough regard to their value to the process. This can happen because auditors take a preexisting work program without researching the nuances of the present audit scope sufficiently or even when they perform planning activities, their interviews and other research only focuses on identifying existing controls without fully understanding the key risks and objectives of the process under review.

Even when auditors perform interviews and walkthroughs, they could allow their accounting bias to steer the questions they ask and the documents they request for examination. When performing controls-based audits, the auditor then listens and searches for references to controls with the intention of verifying their existence and effectiveness. In effect, they are testing the controls in relative isolation, without fully understanding their connection to the underlying objectives and risks of the process or program under review.

Performing risk-based audits requires more brainstorming, more interactions with process owners, a more in-depth understanding of the organization's business, and a mechanism to address past, present, and future vulnerabilities and scenarios that threaten the achievement of business objectives. Since internal auditors are being asked to do more with less, they can't afford to review controls just because they are there. Internal auditors need to assess whether those controls are key to the achievement of objectives and only focus on those that are.

The IIA's publication on the 2015 Common Body of Knowledge (CBOK) global survey is entitled "Driving Success in a Changing World: 10 Imperatives for Internal Audit" and it confirms that the internal audit profession is making substantial progress in making itself relevant to business overall. There is still reference to the expectation gap between what stakeholders consider to be of value and what the internal audit function is delivering. But more than half of respondents now state that their activities are fully or mostly aligned with the strategic plan of their organization.

Chief Audit Executives (CAEs) report they will focus almost as much on strategic business risks (70%) as operational risks (72%). This shows the continued and fundamental shift away from the traditional approach of focusing on accounting/financial controls and instead moving closer to the review of the organization's primary objectives.

The report advises internal auditors to anticipate the needs of stakeholders, develop forward-looking risk management practices, and support the business objectives, identify, monitor, and deal with emerging technology risks and enhance audit findings through the greater use of data analytics. But the report also shows that many organizations are still struggling. In part this is because the environment in which they work is constantly changing; new regulations are constantly legislated and new risks evolve as the world itself evolves, particularly the world of data and technology.

Auditing Beyond Accounting, Financial, and Regulatory Requirements

With all of these matters in mind, it behooves internal auditors to look beyond traditional accounting, financial, and regulatory requirements. In the past, internal auditors predominantly had accounting degrees, graduated from university accounting programs, generally were recruited from external public accounting audit firms, and held CPA certifications. As such, their focus and experience was acquired in the accounting field and saw most audit matters through the prism of accounting requirements.

The other key focus area was compliance with regulatory requirements. In this case, auditors adopted a fairly binary approach to audits by attempting to understand the rules and regulations affecting a program or process. They then would apply a very effective methodology: Are they doing what the rulebook says? If "Yes," the test results were satisfactory. If "No," the results were documented and communicated as findings. In essence, a very predictable pass/fail approach to auditing. For many years, this became the standard operating practice of auditors and even today, some audits require a similar approach due to their regulatory and compliance focus, but we must be careful not to default to this approach when the expectation is broader.

Over time, business leaders and managers witnessed business failures caused by poor management decisions and practices. By poor management, I am referring to inadequate:

- *Operations management.* Some of the related issues are waste, inefficiencies, supplies that arrive late, poor customer satisfaction, and limited capacity to grow as opportunities arise or customers' demands change.
- *Human resources.* As evidenced by poorly supervised, trained, and evaluated employees who sometimes become unmotivated and unproductive.
- *IT.* Computer systems designed with an inaccurate understanding of the business needs and uses of these systems, poor data capture, and inadequate reporting mechanisms.
- *Marketing.* Mass marketing of products and services at a time when customers prefer to feel unique, or wasteful campaigns because they target the wrong audience.
- *CSR.* Issues range from child labor, sweatshop conditions, abusive management, and inappropriate waste disposal.
- Environmental Health and Safety (EHS) practices and conditions related to poor ventilation, excessive heat, extreme noise levels, and workplace hazards caused by chemicals, machinery, and workplace configurations, among others.

Another catalyst enhancing the role of internal auditors and moving it beyond compliance is the increase in stakeholder demands for advisory and consulting activities. Discussions within the

IIA to determine the nature of these activities, whether internal auditors should perform such activities, and to what extent they should allocate resources for this purpose, began in earnest in the 1990s. In many ways, the debate continues today.

By this, I am not suggesting that compliance is a failed effort, or that it does not provide some benefits. It does. Some of the benefits include process improvement, better controlled operations, greater reliability and protection of information, more stable, and predictable process.

The result in many ways is better integration of IT with the business, a greater understanding of the critical nature of management and IT functions and controls, higher funding and resources to improve information capture, analysis, use and security, and a reconsideration of outsourced business and IT functions with a number of companies bringing some of those responsibilities back in-house.

Advisory and consulting engagements are performed to take advantage of internal auditors' broad skillset and experience. Auditors have the unique ability to identify process improvement opportunities without sacrificing the control environment, assess how the related transactions are performed, and determine how risks affect them. Whether performing assurance or consulting activities, internal auditors are expected to act with independence and objectivity, and exercise proficiency and due professional care. High levels of financial, accounting, IT, management, and business analysis skills are typically required to perform these reviews.

The emergence of the conglomerate in the 1970s and the multinational corporation (MNC) in the 1980s has increased the size, reach, and complexity of many organizations. Outsourcing portions of company operations has become commonplace, as is responding to various risks through derivatives and contracting arrangements. Owning companies unrelated to the core business to diversify the revenue stream and being required to meet a plethora of ever-increasing performance expectations and regulatory requirements has become commonplace. The result is that what was a relatively straightforward logistics, supply chain, or treasury audit in the past is now a very complex endeavor involving multiple locations, languages, currencies, regulations, and computer systems.

In light of these dynamics, internal auditors have risen to the challenge by embracing a methodology that goes beyond accounting and more closely aligns itself with the recurring business risks and practices.

The Value Auditors Provide

Internal auditors are unfortunately not always regarded as highly as they should be. Seen as an obstacle, too many managers and employees fail to recognize that internal auditors provide a very valuable service to their clients—whether they are employees of the firm, or hired externally to provide internal audit services.

Internal auditors promote the efficient and effective use of resources. Since organizations operate with the funding received or authorized by their owners or contributors, it is imperative that the organization operates with this principle of financial fiduciary responsibility. The Cornell University Law School Legal Information Institute defines fiduciary responsibility as follows:

> A fiduciary duty is a legal duty to act solely in another party's interests. Parties owing this duty are called fiduciaries. The individuals to whom they owe a duty are called principals. Fiduciaries may not profit from their relationship with their principals unless they have the principals' express informed consent. They also have a duty to

> avoid any conflicts of interest between themselves and their principals or between their principals and the fiduciaries' other clients.[12]

Recognition of the duties that all employees have to the principals is central to the proper discharge of their responsibilities as employees, who should always act in the interests of the main stakeholders of the organization. To this effect, internal auditors contribute to this process by making sure that these duties are defined, that structures are set to ensure behaviors are aligned with these objectives, and making recommendations to the board and senior management when there are discrepancies jeopardizing the success of these arrangements.

In the aggregate, internal auditors serve the public and common interests by making sure that owners receive the return on their investments that they are entitled to, and that the means of generating those profits are within the confines of the law. Beyond shareholders, however, internal auditors help the process of making sure that the interests of all relevant stakeholders are met. Stakeholders can be categorized as economic/primary and noneconomic/secondary.

Economic or market stakeholders are characterized by having a monetary exchange between them. They engage in transactions with the company as it carries out its primary purpose of providing society with goods and services. Consequently, employees, customers, creditors, and suppliers are economic stakeholders. They are sometimes referred to as primary stakeholders as well, because they are critical to the company's existence and activities (Figure 1.1).

A business's relationships go beyond those primary involvements to others. Secondary interactions occur when other individuals and groups show an interest in or concern about the activities of the organization. Noneconomic, nonmarket, or secondary stakeholders are people, groups, or organizations that though not engaging in direct economic exchange with the firm, are affected by or can affect its primary activities and decisions. The list includes communities, the general public, governments, social activist groups, the media, and business support groups (Figure 1.2).

An important aspect of the modern manager and auditor's job is to identify relevant stakeholders and to understand their interests. It is also important to understand the power they

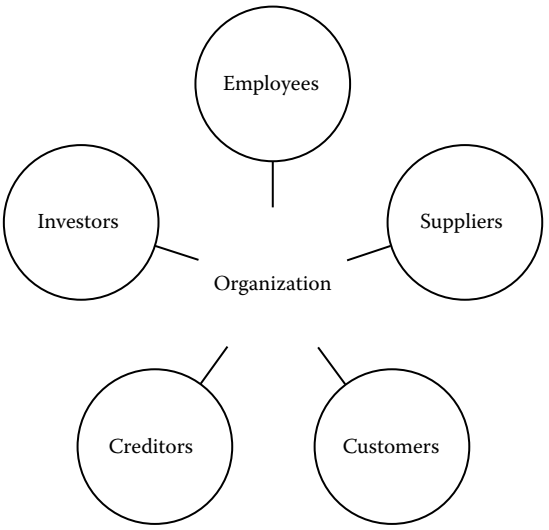

Figure 1.1 Primary (economic) stakeholders.

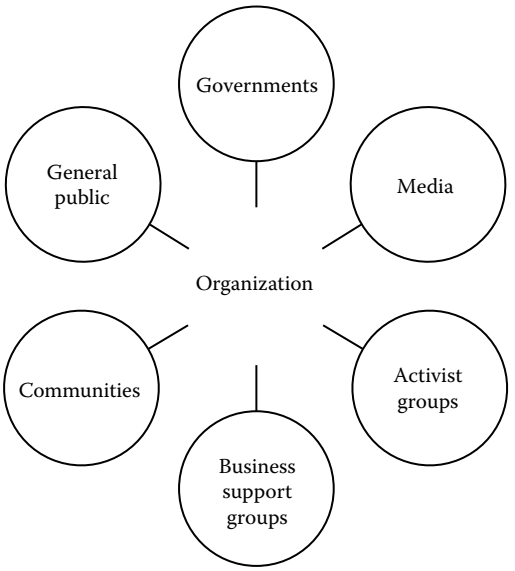

Figure 1.2 Secondary (noneconomic) stakeholders.

have to assert these interests. This process is called stakeholder analysis, which asks three fundamental questions:

1. Who are the relevant stakeholders?
2. What are the interests of each stakeholder?
3. What is the power of each stakeholder?

Since stakeholders refer to persons or groups that affect, or are affected by an organization's decisions, policies, and operations, it is important to identify those parties and document their interests. If stakeholders can facilitate the attainment of objectives, or make decisions regarding resources, it is imperative that auditors understand their role and influence. Since various stakeholders may have varying amounts and forms of power, it is also important to determine what influence they have and how the organization can make sure relations are positive and productive. Stakeholder power is the ability to use resources to make an event happen or to secure a desired outcome. In general, stakeholder power can be categorized as political power, voting power, economic power, and legal power. Mismanaging any aspect of this relationship can stymie the achievement of strategic, operational, compliance, and reporting objectives (Tables 1.1 and 1.2).

Conducting a stakeholder analysis is an important aspect of modern internal auditing, because it gives the auditor an appreciation for the various parties interested in the outputs and outcomes of the organization, its programs and related processes. Organizations are increasingly finding themselves mired in controversy because they didn't anticipate, or properly manage the expectations of these diverse constituencies. To the extent that internal auditors can help management identify, plan for, and respond effectively to the primary and secondary stakeholders, the organization will encounter less pushback and it will likely be able to operate with fewer disruptions. In addition, during the planning phase of any audit, planners should identify the internal and external stakeholders involved to make sure they seek their input as to what their objectives, concerns, and plans are for the area audited. This will result in more effective and value-added reviews.

Table 1.1 Primary Stakeholders, Nature of Interest, and Power

Stakeholder	*Interest*	*Power*
Employees	Maintain stable employment Receive fair pay Work in a safe, comfortable environment	Bargaining power Work actions, strikes, and lawsuits Publicity
Suppliers	Receive regular orders for goods/services Be paid promptly	Refusing to meet orders Supplying to competitors
Customers	Receive value and quality for money Receive safe, reliable products	Purchasing from competitors Boycotting Refusing to pay
Creditors	Receive repayment of loans Collect debts and interest	Calling loans Use legal authorities to repossess assets
Investors	Receive a satisfactory return on investments Realize an appreciation in value	Exercise voting rights Ability to inspect company records and reports

Source: Adapted from Lawrence, A. T., Weber, J., and Post, J. E. 2011. *Business and Society: Stakeholders, Ethics, Public Policy* (11th ed.). Boston: McGraw-Hill Irwin.

Table 1.2 Secondary Stakeholders, Nature of Interest, and Power

Stakeholder	*Interest*	*Power*
Governments	Promote economic development Raise revenues through taxes	Adopting regulations and laws Issuing licenses and permits
Media	Keep the public informed Monitor company actions	Publicizing events that affect the public
Activist groups	Monitor company actions for ethical and legal behavior	Lobbying government for regulations Gaining public support
Business support groups	Provide research and information to improve competitiveness	Using staff/resources to help companies Providing legal political support
Communities	Employ local residents Ensure local development	Issuing/restricting operating licenses Lobbying government for regulations
General public	Minimize risks Achieve prosperity for society	Supporting activists Pressing government to act Praising or condemning companies

Source: Adapted from Lawrence, A. T., Weber, J., and Post, J. E. 2011. *Business and Society: Stakeholders, Ethics, Public Policy* (11th ed.). Boston: McGraw-Hill Irwin.

Identifying Operational Threats and Vulnerabilities

The traditional approach to internal auditing was to perform postmortem reviews to verify that what was done was done appropriately. This was a practice that followed in the footsteps of public accounting firms, which inspect transactions that occurred during the preceding fiscal year. Internal auditors need to go beyond inspecting transactions long after they were performed because the focus now leans toward an examination of future threats and vulnerabilities that can derail the organization's goals and objectives in the short, medium, and even the long term. In fact, focusing on future events and the future implications of present events would add more value to their organizations than reporting primarily on past events. When this happens, as has been common practice in the past, the organization dedicates itself on correcting past issues, which creates rework.

These future-oriented threats and vulnerabilities can be

Operational, such as maintaining operational capacity, speed of execution (i.e., cycle time), staffing levels, employee motivation, knowledge transfer, system development, and implementation

Technological, including protection of intellectual property and personally identifiable information, denial of service attacks, business continuity due to staff turnover, and system development

Strategic, referring to concerns related to strong customer and vendor relations, customer loyalty, building effective business partnerships, outsourcing arrangements, and mergers and acquisitions

Environmental, which may include reliable supply of water and electricity, achieving a lower carbon footprint, and reducing the amount of natural resources used during business activities

These threats and vulnerabilities can be evaluated in the medium and long terms, but also beyond the national borders of the organization's country of operations. As such, internal auditors are engaged in international auditing, evaluating home office and host country dynamics, finding out if local laws exist, whether they are enforced and how, and which requirements supersede which, if applicable. Even political issues, social unrest, and demographic shifts are of importance to today's auditors, since any of these changes can affect their organizations and their ability to achieve their objectives economically and in timely fashion.

All of these dynamics requires internal auditors to take a more futuristic view of their roles, be informed about dynamics in their industries, countries, and regions, and not only the microcosm of their organizations as they may have been doing in the past. The IIA's 2015 Global Pulse of Internal Audit, Embracing Opportunities in a Dynamic Environment states "The mandate to address emerging and evolving risks is clear. Risks are emerging at an unprecedented pace, and stakeholders' impatience with surprises is evident." (p. 8). The implications of this statement are profound. Internal auditors can no longer be content with reviewing the accuracy, completeness, and authorization of compliance and financial transactions. It is no longer enough to audit from the perspective of stated controls "ticking and tying" transactions from one source to a recorded entry, but most apply a far more dynamic and insightful methodology—one that is risk based.

The Skills Required for Effective Operational Audits

The paradigm shift in the work of internal auditing from being controls-based to risk based means that internal auditors must acquire and apply different skills to their trade from what they did in the past. Auditors must examine risk exposures and the measures in place to address more than accounting and financial risks. So what skills are helpful?

According to the IIA Research Foundation Core Competencies Report, the following are the top general competencies of internal auditors:

1. Communication skills, such as oral, written, report writing, and presentation skills
2. Problem identification and solution skills, such as conceptual and analytical thinking
3. Ability to promote the value of internal audit
4. Knowledge of industry, regulatory, and standards changes
5. Organization skills
6. Conflict resolution/negotiation skills
7. Staff training and development
8. Accounting frameworks, tools, and techniques
9. Change management skills
10. IT/CT[13] framework, tools, and techniques
11. Cultural fluency and foreign language skills

The three common core competencies identified in the report are communication skills, problem identification and solution skills, and keeping up to date with industry and regulatory changes and professional standards. These results highlight the importance of individual and team competencies and the role they play in team effectiveness.

In terms of behavioral skills, internal auditors should possess the following skills:

- Confidentiality
- Objectivity
- Communication
- Judgment
- Work well with all management levels
- Possess governance and ethics sensitivity
- Be team players
- Relationship building
- Work independently
- Team building
- Leadership
- Influence
- Facilitation
- Staff management
- Change catalyst skills[14]

How to acquire these skills should be done along two dimensions. One at the individual level and the other at the internal audit unit level.

At the individual level, internal auditors, like most professionals today, are expected to take ownership of their own training and development and not leave it to their employers to decide

and implement. Whereas, in the past, it was common for employees to take a passive approach, waiting for their employers to tell them when, what, and why training would occur, today's auditors should take a more active and engaged approach to their training needs. They should

1. Reflect on their present competencies, identify their job needs, and perform a gap analysis to meet their current skill requirements
2. Define their career ambitions and chart a roadmap to acquire the skills and competencies needed in the future

Internal auditors should balance their training activities so they not only enhance their technical skills, but also their soft skills. I believe the term soft skills is a misnomer because they are as important as technical skills. In fact, they can be more important as anyone who has worked with a technically exceptional individual who can't explain what he is doing, did or plans to do, and why, knows.

Communication skills are also essential not only as it relates to fellow auditors, but also process owners and operators. All too often, internal auditors are unable to explain their activities, the reasons for testing certain items, or the implications of their findings to nonauditors. This inability to explain matters clearly diminishes the impact of their findings and the persuasiveness of their recommendations. This fact is supported by KPMG's Seeking Value through Internal Audit report which polled audit committee chairs and chief financial officers (CFOs). The report states that internal audit needs to improve communication skills (67%) and technology skills (62%).

At the internal audit unit level, the department should perform a skills analysis to identify their present skill repertoire, and those needed to perform audit and other reviews competently in the next 3–7 years. Organizations are increasingly performing multiyear risk plans to make sure their work is synchronized with the organization's strategic initiatives. This is a great opportunity to expand the identification of future work, but also determine how prepared the department is to meet those challenges.

The IIA Research Foundation Internal Audit Capability Model (IA-CM) can be used to assess the internal audit department's current condition and also as a visioning tool, helping to draft the course and expectations for the internal auditing function. The 5-level framework identifies conditions and practices that internal auditors should review, and use as a roadmap for continuous improvement from Level 1- Ad Hoc/Initial to Level 5—Optimizing/Change Agent (Table 1.3).

Integrated Auditing

> Business changes, resources change, and risks change, so both operations and IT must adapt and continually improve to support the business and mitigate risks to acceptable levels.

Another important development over the past decades is the emergence of integrated auditing as a type of audit. These are characterized by the simultaneous inclusion of business and IT subjects in the review. Whereas in the past traditional auditors would perform a review of accounting/financial controls, and IT auditors would perform their assessment of IT risks and controls separately, during the 1990s this new practice, commonly referred to as integrated auditing, emerged.

Table 1.3 Internal Audit Capability Model (IA-CM)

Level	*Characteristics*
Level 5: Optimizing	Internal auditing recognized as a change agent Internal audit is recognized as a key change agent, continuously improving its professional practices, integrating performance data, global leading practices, and feedback to continuously strengthen the unit and the organization. It plans its workforce needs strategically and maintains effective ongoing relationships with other units within the organization to understand the organization's strategic directions, emerging issues, and risks
Level 4: Managed	Overall assurance on governance, risk management, and control Internal audit provides overall assurance on governance, risk management and control, contributes to the development of the organization's management, supports professional bodies, has a planning mechanism for its workforce, and uses quantitative and qualitative metrics. It coordinates its activities to be sufficiently comprehensive and provide reasonable assurance at a corporate level that GRC processes are adequate and functioning as intended to meet the organization's objectives
Level 3: Integrated	Advisory services Internal audit provides guidance and advice to management. These advisory services add value without the auditor assuming management responsibility. These services are directed toward facilitation rather than assurance and include training, system development reviews, performance and control self-assessment (CSA), and counseling. Internal audit focuses on team building and competency, developing a professionally qualified staff and effective workforce coordination within the unit and with other review groups. It uses output performance measures and tracks cost information. Internal audit is an integral component of the organization's management team
Level 2: Infrastructure	Compliance auditing The internal audit function focuses on compliance audits, which evaluate conformity and adherence with internal policies, laws, regulations, contracts, and other agreements or requirements that preside over the activities and goals of the area, process, or system being audited
Level 1: Initial	Ad hoc/isolated audits The internal audit function is unstructured and operates in an ad hoc manner. It performs isolated audits primarily examining documents and transactions for accuracy and compliance. The audit team is often part of a separate organizational unit with no established capabilities or infrastructure to support the function.

Source: Adapted from the 2009 IIARF Internal Audit Capability Model (IA-CM) for the Public Sector.

As we examine the approach employed by public accountants, their focus was centered on financial assertions, such as occurrence, completeness, accuracy, classification, existence, and valuation of accounting, and financial information, as inputs for the organization's financial statements. It is important to remember the key objectives of financial audits:

- Ascertain whether in all material respects, the income statement and the statement of cash flows accurately and reliably reflect the activities during the fiscal year
- Ascertain whether in all material respects, the balance sheet shows the condition of the organization as of the last day of the fiscal year

At the other end of the spectrum, we can place highly technical IT reviews, involving matters like database configuration and security, user authentication, operating system reliability, and network perimeter security. Between these two extremes, we can place IT general controls, such as physical security and environmental controls, backup procedures, user authorization, business process controls surrounding reconciliations, and exception reporting. Other areas of focus include production and change management, disaster preparedness and recovery, and business continuity.

This dynamic can best be shown as in Figure 1.3.

Financial and operational auditors are increasingly expanding their focus and incorporating IT applications and general IT topics in their reviews. Conversely, IT auditors, who have traditionally focused on IT technical subjects including general and application matters, are increasingly widening their view and including operational and financial elements to their review. This means that operational and financial auditors need to know the systems in use, and IT auditors need to know the business and how it uses the systems in place.

This approach is a refreshing departure from the previous practice of conducting financial audits, operational audits, and IT audits, all separate and at different points in time, of the same unit. This antiquated approach was disruptive to the organization, costlier due to the repeated reviews by different audit groups, and when communicating results, it did not provide a comprehensive view that linked process, finance, and IT in one audit report.

Furthermore, over time it became apparent that accounting/financial controls are increasingly dependent on computer systems. For example, exception reports, which identify transactions that do not meet preestablished criteria, are the result of a computer algorithm that defines rules. When these rules are not met, the transactions are noted on these reports for review and resolution. If traditional internal auditors don't understand the exception rules, and don't know how to review the code in the system to verify its accuracy, the reliance placed on the exception report could be misplaced.

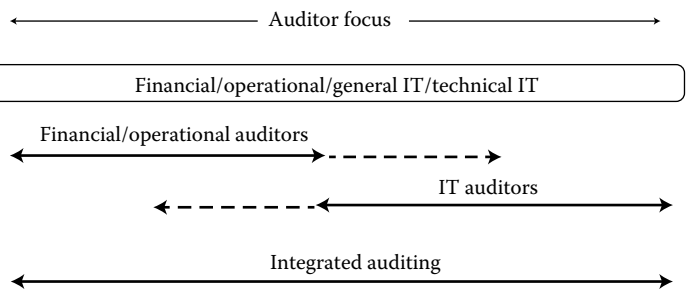

Figure 1.3 Integrated auditing.

Another example has to do with reports and reconciliations. As noted above, if the algorithm in the computer systems is not understood, and the procedures to check it are unknown, how can anyone rely on these reports? Both members of management and internal auditors could be relying on system-generated reports that contain unknown errors. If the auditors don't know how to review the underlying computer code, they could be signing off on faulty information, which would negatively affect the assurance they are supposed to provide to the board and management.

So, integrated audits are designed to address IT questions while simultaneously examining the business dynamics. In small organizations, it was, and may still be possible in some cases, to have individual auditors who have the depth of knowledge to examine both the accounting/financial and the IT aspects of business operations. As organizations grow in size and complexity, it is more common today to achieve integrated audits through team composition. These reviews require coordination so that auditors work from a single risk matrix that identifies all relevant objectives, risks, controls, and audit steps, the related documentation crosses over smoothly and the resulting report is comprehensive in its coverage of operational, financial, and IT subject areas.

The Standards

The IIA, which is the governing body of internal auditors worldwide, provides guidance for internal auditors on what should be done, how it should be done, and why. Adhering to the International Standards for the Professional Practice of Internal Auditing (*Standards*) is mandatory, while following the guidance provided in the Practice Advisories and Practice Guides is highly recommended and encouraged.[15] I have found these documents quite insightful and following their directives has enabled me perform numerous audits over the years with very positive client feedback. I have also learned that beyond the words and what the *Standards* state, it has been very beneficial to understand why these standards are in place.

The following passages and related commentary represent a selection of standards relevant to operational auditing and reflections on my experience implementing them in my work.

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

Internal audit is not a static profession, but rather one where its practitioners must remain proficient in terms of knowledge and skill to perform their duties effectively. Being qualified upon hire is one thing. Internal auditors must make sure they remain qualified throughout their career. This of course is a big challenge because business dynamics are constantly changing, but there is no alternative and we must keep up with the changes affecting our organizations. Internal auditors must adopt a learning mindset, continue to educate themselves, and stay up to date.

One of the greatest assets auditors have is their credibility. They earn this by delivering consistently accurate, useful, and timely communications that incorporate insightful opinions and recommendations when appropriate. Credibility cannot be achieved if the auditor lacks knowledge about the organization and the linkages between the issues noted, the causes of these issues, and an appreciation for the priorities and challenges of the organization. A deep understanding of the organization will make it possible to also understand the context in which issues are occurring.

This in turn will help to formulate pragmatic and business-appropriate recommendations that get to the root cause of the issues identified.

This knowledge base is important at the individual auditor level and at the department level. When there are skill deficiencies, the CAE must take action to recruit, train, and develop the auditors in the department so individually and collectively they have the ability to perform high quality reviews.

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

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

Organizations are increasingly relying on computer systems to capture, manipulate, and interpret data that helps guide them toward the achievement of their objectives. This means that internal auditors need to know how these computer systems are configured and operating to ensure accuracy and protection of the underlying data. It is also essential that the financial and nonfinancial reports generated from these systems be reliable. Furthermore, internal auditors must also know how to use technology-based audit techniques to better understand and evaluate the large volumes of data collected, how it is manipulated, and how the resulting information is disseminated to relevant stakeholders.

Using these technology-based audit techniques allows auditors to examine very large amounts of data that would be impossible or unfeasible to do manually. This is often referred to as computer-assisted audit tools and techniques (CAATTs). Those who have adopted this practice often reduce the amount of time and effort it takes to evaluate these large volumes of data as they automate the audit process. There are many tools available for auditor use, including ACL, IDEA®, Minitab, SAS, and many others. Microsoft Excel and Access are also very capable tools for a wide variety of tests.

These computer programs allow auditors to extract and analyze large volumes of information and build conclusions based on the entire population, instead of a limited sample of the population. This avoids the challenges of building conclusions based on a limited sample of the population.

Another important aspect of technology-based techniques is the use of electronic workpaper packages for workpaper and project management, document retention, and team collaboration. There are many benefits to keeping a centralized repository of audit workpapers. These include ease of storage and retrieval of current and past workpapers, backups of the documents, remote access, coordination among team members, and standardization of forms and procedures. Some commonly used tools include Teammate, Magique Galileo, Compliance 360, and Auditor Assistant.[16]

Acquiring these skills should commence upon hire and it applies to auditors of all specialties, not only IT auditors.

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

While performing risk-based auditing, internal auditors must remember that the focus of their work is not limited to assurance considerations unless it is mandated as such, or the scope of the

audit is defined that way specifically. Otherwise, reviews must also include the operational aspects of the program, process, or organization being examined. Success can be measured using a variety of criteria and success is not achieved only by meeting compliance expectations.

There are many organizations that experienced financial hardship, up to the point of bankruptcy, even though they adhered to generally accepted accounting principles and compliance requirements. This failure can be gradual or sudden and can happen in the short term or over a long period of time. General Motors, Chrysler, BlackBerry, CIT Group, Lehman Brothers, Kmart, Eastman Kodak, and Delphi are only a few examples of organizations whose difficulties were not due to compliance failures per se, but rather the poor management of operational and strategic risks.

> *2010—Planning. The CAE must establish a risk-based plan to determine the priorities of the internal audit activity, consistent with the organization's goals.*

The internal audit department's audit plan, which identifies the audits that will be performed by the internal audit function, must be based on the identification and measurement of risks to the organization. In the past, many internal audit departments developed and executed audit plans that followed other criteria and were characterized by cyclical and often repetitive reviews. Sometimes these audits were not the most needed based on past issues or organizational priorities, but were seen as safe and consistent with what internal auditors traditionally examined.

The result is that the auditors performed "safe" audits repeatedly, like expense reports, petty cash, accounts payable, and accounts receivable, which are not a bad idea in and of themselves. But I have witnessed cases where these same auditors had never examined key IT activities and IT development projects, bonus payouts, marketing activities, construction projects, treasury activities, customer fulfillment cycle times, and the management of outsourced activities, which represented far higher risks to the organization.

> *2120—Risk management. The internal audit activity must evaluate the effectiveness and contribute to the improvement of risk management processes.*

By auditing what matters most, the limited resources available will be spent more wisely and the communications resulting from those reviews will be far more valuable to the board and management.

Among the responsibilities of the board and management is establishing a mechanism to identify, measure, and determine the best way to respond to relevant risks to the organization. Internal auditors for their part, should ascertain to what degree this mechanism and its underlying processes are effective. This assessment relies heavily on the determination that the organization's vision and mission are clear, provide a sense of direction, and are supported by the organization's structure and objectives. Also that significant risks are identified and assessed, and appropriate risk responses are selected that align risks with the organization's risk appetite.

There are very specific roles presented here that I want to reiterate: the board and management establish the structure and mechanism of the risk management processes, while internal audit evaluates, verifies the degree of effectiveness, and recommends improvements where appropriate.

A large number of organizations do not have risk management processes in place, and many that do, experience limited success with them. It behooves all involved to take action in this regard.

> *2120.A1—The internal audit activity must evaluate risk exposures relating to the organization's governance, operations, and information systems regarding the:*
>
> - *Achievement of the organization's strategic objectives*
> - *Reliability and integrity of financial and operational information*
> - *Effectiveness and efficiency of operations and programs*
> - *Safeguarding of assets*
> - *Compliance with laws, regulations, policies, procedures, and contracts*
>
> *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:*
>
> - *Achievement of the organization's strategic objectives*
> - *Reliability and integrity of financial and operational information*
> - *Effectiveness and efficiency of operations and programs*
> - *Safeguarding of assets*
> - *Compliance with laws, regulations, policies, procedures, and contracts*

I mention these two *Standards* together because they address areas of focus related to risk exposures (2120.A1) and controls (2130.A1), and share similar language. The focus of the internal audit activity is broad and complex. It must evaluate risk exposures related to the organization's governance, risk management, and compliance infrastructure, the design and function of its operations, and the reliability of its IT infrastructure. All of these elements must also be examined in relation to the organizations':

- *Strategy.* Organizations should have a plan of action, related policies, and a suitable structure so they increase the likelihood of achieving their mission and see their vision become reality.
- *Financial and operational information.* The quality of financial information has received a great deal of attention from external and internal auditors alike for many years. However, opportunities generally abound when it comes to operational information where I often find that it is insufficient, unreliable, or too generalized to provide the level of insight that managers and their staff need. Other common issues include the limited ability to generate needed reports from computer systems and the excessive restrictions on access to information, well beyond what segregation of duty considerations might dictate. This in many ways explain why so many organizations still rely disproportionately on spreadsheets to run the organization even though they spend heavily buying, configuring, deploying, and maintaining ERP systems.
- *Effectiveness and efficiency*. While most auditors perform tests to determine levels of accuracy, completeness, classification, and valuation of transactions, not enough emphasis has been given to the organization's ability to achieve its objectives (i.e., effectiveness). In fact, many organizations lack clearly stated, cascading, and interrelated objectives that begin at the enterprise level, and are sufficiently linked downward through the business unit, department, and process, and down to the individual level. On the other hand, efficiency has received limited coverage over the years from internal auditors, whose focus has been on

compliance and financial risks resulting in few findings that target long cycle times, waste, redundancies, bureaucracy, and rework.

- *Safeguarding of assets.* External and internal auditors routinely examine the purchase, use, safeguarding, valuation, depreciation, and disposal of assets. In fact, for many auditors reviewing the existence, condition and accounting of land, buildings, machinery, vehicles, and inventory is part of every year's annual plan and these items receive the scrutiny they deserve. What may be also important to examine is whether there are other assets that have not received sufficient attention. For example, the expression "people are our greatest asset" has reached the level of being a cliché, but is true for many organizations. In fact, the knowledge, work discipline, creativity, motivation, and collaboration displayed by employees become the key wealth generator in many organizations. So we should ask ourselves, have we examined human resources from that perspective?
- *Compliance.* I have already expounded on the pivotal role that compliance has had on the internal audit profession and this aspect of our role will remain important indefinitely. But when we consider compliance we should also pay close attention to the complexities that modern day organizations are exposed to. I am referring for example to cosourcing and outsourcing and the fact that this raises liability issues, performance management, and the safeguarding of data and personnel. Personal and data protection are becoming increasingly important as otherwise strangers have physical and logical access to data, facilities, assets, customers, and vendors.

  The following are some questions to illustrate the complexities of modern day compliance:

  - How do we know if these third parties are themselves further outsourcing our data and work?
  - Are their values aligned with ours so there are no unethical practices in place?
  - How exactly do they screen their employees before they begin working on our account?
  - How quickly would they notify us if they experience financial or other forms of hardship so we are not surprised by business disruptions?
  - Are they billing us accurately for the work they are doing?

2130—Control. The internal audit activity must assist the organization in maintaining effective controls by evaluating their effectiveness and efficiency and by promoting continuous improvement.

While internal auditors have focused on internal controls for decades, the IIA states that internal auditors must assist their organizations in maintaining effective controls. This means first of all, that the board and management own the internal controls and internal auditors assist them by verifying that the controls are effective. In addition, this standard also indicates that internal auditors should go beyond the effectiveness of these controls, but also examine their efficiency. In other words, avoid wasted resources, time, or effort while performing the control activity. Lastly, and in regard to promoting continuous improvement, while examining the current situation is pertinent, internal auditors must also help management embrace the practice of continuous improvement to always search for faster, cheaper, and better ways of performing control activities.

Because an action was effective in the past, it does not mean that it will continue to be effective in the future. In fact, stubbornly maintaining the status quo when conditions warrant modification can be costly and impair future success.

2201—Planning considerations In planning the engagement, internal auditors must consider:

- *The objectives of the activity being reviewed and the means by which the activity controls its performance*
- *The significant risks to the activity, its objectives, resources, and operations and the means by which the potential impact of risk is kept to an acceptable level*

This standard is one of my favorites. It states that while planning engagements we must consider the objectives of the entity, program, or process being audited and how management controls its performance, as well as the risk management procedures in place. Over the years, I have found that

- A large number of employees have unclear or unknown objectives
- The programs and processes they work in also lack clear objectives
- When there are objectives, there are often few if any metrics in place to gauge the achievement of these objectives
- Risk identification, assessment, and management procedures are limited or nonexistent, so there is no clear mechanisms to ascertain what the organization does to keep these risks at an acceptable level

Given these gaps, internal auditors have many opportunities to add value to their organizations while they work on meeting the requirements of this standard.

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

When engaged in business reviews, internal auditors are encouraged to

- Incorporate the elements of integrated auditing so auditors apply a holistic view during their work
- Evaluate the people, processes, and technology relevant to the review being performed, and, examine third parties' systems, records, personnel, and properties under their control

These requirements are a reflection of the highly important role that outsourcing and cosourcing have had on organizations over the last several decades, and that from all appearances will continue well into the future.

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

Internal auditors collect, analyze, and interpret data to prove/disprove hypotheses regarding the design and function of processes and systems as they relate to the achievement of objectives, and the effectiveness of risk management procedures. Internal auditors must also communicate their conclusions and this requires that their communications be persuasive. To accomplish this, communications must meet the requirements of

- *Sufficiency.* This means that the auditor needs enough information, including quantifiable facts and figures.

- *Reliability.* Meaning that the information must be trustworthy and free from distortion.
- *Relevance.* This relates to the information being consistent with the objectives and scope of the review.
- *Usefulness.* This relates to the information helping the organization accomplish its objectives.

Quite often, when clients express confusion, disagreement, or skepticism about the internal auditors' communication, it is because the auditor has not met one or more of these four attributes.

> *2330—Documenting information. Internal auditors must document relevant information to support the conclusions and engagement results*

Internal auditors must make sure that in all aspects of their work, they base their conclusions and support their communications with facts. The rigor of their data collection activities, the sophistication of their analysis, and the maintenance of detailed records of the items examined and procedures performed, will increase the likelihood that management will accept the observations presented and be more inclined to accept the recommendations made. Any shortcuts are at the auditors' peril.

While intuition can be helpful in many situations, it can be a very problematic ingredient in the auditors' toolbox if it is not supported by facts and explainable procedures. All conclusion and results must be substantiated and referenced in the corresponding workpapers or the auditor's work could be in question.

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

Internal auditors have traditionally provided exception-based reports. This term means that internal audit communications address what is abnormal or unexpected in the areas examined during the review. While there is a great deal of value in providing reports to the board and management that identify issues noted, the long term and continuous effect of providing exception-based reports is often less than positive. These reports are eventually interpreted by others as meaning that internal auditors only look at what is broken and embark on "gotcha!" expeditions. Furthermore, if an auditor examines 10 areas within their scope of work, and finds issues with two of these 10 areas and reports only on these, audit clients will wonder if the auditor even noticed that eight of the 10 areas examined met performance expectations. The reports could be perceived as being unfair and biased.

To address this misunderstanding, and the resulting halo effect that this would cause, internal auditors should acknowledge satisfactory performance in their communications. Over the years, I have done this in a variety of ways. If the report is relatively short, a sentence may suffice. For longer reports, I sometimes provide a full paragraph.

I once had a client that wanted a full section on best practices identified. This company built power stations and each site was a self-sustaining operation. Senior management knew that there was no need for an employee in one location to interact with that person's counterpart at another location, and best practices known by one was not likely to be known by another. Since internal audit traveled to multiple locations and was privy to operating practices, audit reports were shared among locations with two underlying messages for the staff involved:

1. Note what other facilities are doing well and emulate it if possible
2. Note what other facilities are doing poorly and make sure that is not happening in your location. If so, fix it before internal audit visits you

This was a well-run organization with enviable governance practices!

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

One of the most important aspects of internal auditing is effective communications. Although internal auditors spend many hours planning, performing fieldwork, and writing the report, the client does not see most of this effort. Our product is the audit report, so it must impress the client.

Effective verbal communications are also essential for effective audits and overall success. They help auditors communicate the objectives for the audit and methodology that will be used. It also makes it possible to get the needed documents and win support for recommendations, while helping to build healthy relationships.

Effective communications, whether written or verbal, meet these seven attributes:

1. *Accurate.* There are no mistakes or errors in the information presented.
2. *Objective.* The auditor's work is focused on facts and informed judgment, there is no bias involved, and the results are neither inflated nor understated.
3. *Clear*. Easy to understand and interpret.
4. *Concise*. Brief by using only as many words as necessary—gone are the days of very lengthy reports.
5. *Constructive.* Serves the purpose of helping the organization improve its activities and promote advancement through excellence.
6. *Complete.* Nothing relevant or important missing.
7. *Timely.* Issued promptly because the value of the message decreases with time.

Summary

Internal audit is an evolving profession. The last few decades have brought an unprecedented number of changes to the operational, technological, economic, and social environment in which organizations operate and internal auditors must respond accordingly. The required adaptation involves redefining what we audit, how we audit, when we audit, who performs the audits, and even where the audits are performed.

The role of internal auditors has evolved so that we are now expanding our scope of work beyond accounting records and financial statements. Today, internal auditors are expected, in fact required, to examine how well the organization is organized, how efficient it is in its daily activities, and how effective it is in its pursuit of its stated mission, vision, and objectives. The internal auditors' review often means collecting and analyzing more than 1 year's worth of data and documents, talking to people outside the accounting and financial reporting offices, and literally interacting with everyone from the boardroom to the mailroom.

The skills requirements are increasingly diverse and go beyond accounting degrees and related experience. In fact, internal audit departments are increasingly searching for individuals who can "think risk," communicate effectively verbally and in writing, collaborate with others within and

outside the organization, understand the connections linking operating units together, and understand process flows as much as they understand the systems that support them.

The guidance available to internal auditors is extensive and detailed. But having this guidance does not guarantee that auditors will apply them effectively. We must understand what the guidance says, why it must be followed, be able to adapt its implementation to fit the circumstances and maturity of our organizations, and articulate the merits to our clients. From design to execution, internal auditors must think outside the box and display leadership and adaptability. The past focus on compliance was too limited, because organizational success depends on far more than complying with rules and regulations. Organizational success depends on the effective implementation of governance mechanisms and structures, visioning and seamless execution, effective risk identification, hiring and deploying the best people possible, and exceeding the expectations of a diverse and demanding collection of stakeholders. The risks have never been higher. The opportunities have never been more promising. Internal auditors must rise to the occasion and assist the board and management meet these expanding responsibilities.

KPMG's Seeking Value through Internal Audit report states that in their survey it is clear that while companies want measurable impact from their internal audit functions, especially in the areas of risk and potential revenue enhancement, this does not constitute the primary concern of the audit committee chairs and CFOs polled. The study found that the most important factor is effectiveness and efficiency. This means that, while there is a call for measurable impact through a greater focus on risk, it should not come at the cost of reducing audit effectiveness and efficiency.

In response to the question: How important are the following to CFOs and audit committee chairs? The responses are shown in Table 1.4.

Metrics represent a great tool to measure performance and ascertain the degree to which goals are met. It is primarily a management tool, but we will also examine how internal auditors can use metrics to better gauge risks, the effectiveness of internal controls, and detect anomalies earlier than the traditional cyclical audit approach.

Finally, there is an indissoluble link between the processes designed to pursue the mission and goals of the organization, the people who work within those processes, and the systems that support both the processes and the people. In Chapter 2, we will examine this connection, its implications for internal auditors, and how to use this knowledge to perform more effective operational audits.

Table 1.4 How Important Are the Following to CFOs and Audit Committee Chairs?

Response	*Percentage*
Performance of effective and efficient audits	71
Measurable impact	63
Quality of IA reports	52
Commitment/technical excellence/quality	44
Appropriately qualified personnel	41
Clear standards/robust tools	35

Chapter 2 explores the objectives and characteristics of operational reviews and what internal auditors must consider when embarking on an operational audit of their own. We discuss the planning, fieldwork, and reporting phases, key considerations during each of these phases and how to navigate the multiple requirements of each more smoothly and effectively to achieve greater client satisfaction. It also explains the need for metrics to monitor business activities.

Effective business operations are the result of the deployment and coordination of resources for the pursuit of business objectives. Organizations exist to pursue a mission and processes are designed to that end. These processes are in turn staffed by people whose number and skillset advance the mission and are assisted by technology or machines. Consequently, success is the result of proper planning and the effective alignment of people, processes, and technology.

QUESTIONS

1. What is operational auditing and how can it add value to the organization?
2. Explain the importance of independence and objectivity and how having unfettered access within the organization impacts the internal auditors' ability to review any program, process, system, record, at any time and perform operational reviews.
3. Describe the difference between retrospective reviews that focus on past events and prospective engagements. List some of the future threats that internal auditors should include in their assessments.
4. What are five of the skills of internal auditors that have been identified as essential for success in the future? What can your internal audit department do to develop those skills among its staff?
5. Explain the five stages in the IA-CM and its implications for operational auditing.
6. Explain integrated auditing.
7. Describe the difference between controls-based and risk-based auditing.
8. Explain the importance of using business objectives while planning and performing operational audits, and how to use them when communicating the results of the audit.
9. What are the attributes of effective audit evidence outlines in Standard 2310 and what the implications for operational audits?
10. Explain how an organization could meet its compliance requirements but still fail over the medium and long term.

Notes

1 Quote from John B. Petersen III's blog Product of the Product at http://www.jbp3.com/blog/product-of-the-product
2 See https://daf.csulb.edu/offices/univ_svcs/internalauditing/audits.html
3 See http://www.businessdictionary.com/definition/operational-audit.html
4 To read more about the advocacy work of the IIA, see https://na.theiia.org/about-us/about-ia/Pages/About-IIA-Advocacy.aspx
5 To read the full article, see http://usatoday30.usatoday.com/news/nation/2002-12-22-persons-of-year_x.htm
6 The IIA's website www.theiia.org provides the definition of internal auditing in multiple languages and the full text of the Standards for the Professional Practice of Internal Auditing.
7 For more information regarding the Global Reporting Initiative, visit https://www.globalreporting.org/Pages/default.aspx

8 See IIA Organizational Governance Position Paper, July 2006.
9 Part of the definition is adapted from https://en.wikipedia.org/wiki/Operational_auditing and most of the commentary regarding operational auditing is based on my almost 20 years of being involved in the profession.
10 See https://na.theiia.org/membership/Pages/Membership.aspx
11 For details regarding the International Professional Practices Framework (IPPF), its components, and the requirements for internal auditors, see https://na.theiia.org/standards-guidance/Pages/New-IPPF.aspx
12 See https://www.law.cornell.edu/wex/fiduciary_duty
13 Information Technology/Information Communication Technology.
14 Full details are available in the 2010 Institute of Internal Auditors Global Internal Audit Survey: A Component of the CBOK Study report entitled: Core Competencies for Today's Internal Auditor (Report II) by James A. Bailey.
15 Starting in July 2015 and through 2016 and 2017, the IIA will be enhancing the IPPF and expanding both the Implementation Guidance and Supplemental Guidance. See https://na.theiia.org/standards-guidance/Pages/Standards-and-Guidance-IPPF.aspx
16 A list of software tools is available at https://www.iia.org.au/technicalResources/software-directory