



## MINISTRY OF FINANCE OF MONTENEGRO



# INTERNAL AUDIT MANUAL

## Version 3

October 2011



The document has been produced with the assistance of EU

This document – Financial Management and Control Manual – was produced by the Ministry of Finance – Central Harmonisation Unit, with the assistance of the EU. The document does not constitute a formal communication and does not necessarily represent the official position of the European Union.

With the aim of improvement of the financial management and control system, this Manual will be the subject of continuous review and will be updated by the CHU of the Ministry of Finance.

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IPA 2009 project „Strengthening the management and control systems for EU financial assistance in Montenegro“, EUROPEAID 129081/C/SER/ME, 09ME01.9.1 implemented by consortium of East West Consulting, Eurecna and Sofreco.



# **PART ONE: INTERNAL AUDIT STANDARDS, POLICIES AND PLANNING**

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## FOREWORD

The quality of Internal Audit performance in public institutions depends on the application of the rules and methods presented in this Manual, as well as your full involvement as a professional. Professionalism depends significantly on the objectivity of your views and judgement, the quality of the thought processes in applying Audit Standards and the impact and practicality of your recommendations.

The manual is based on the internationally accepted standards developed and adopted by the Institute of Internal Auditors. To help you in your day-to-day work the relevant standard is shown, where appropriate, at the start of each main section of the manual.

Internal Audit does not play an inspectorial role. It needs the co-operation of staff and managers in order to obtain sufficient genuine information to carry out its duties. The best way to foster an atmosphere of mutual trust and co-operation is for Internal Audit to adopt a participative approach, be transparent in its work and objectives and to maintain professional relationships at all times.

It is essential therefore that the requirements of this Manual are complied with to ensure a consistently high standard of internal audit to be delivered. However, auditing is an art rather than a science and the manual is not intended to mechanise the audit process. Professional judgement remains an essential feature in applying many areas of our approach.

## **PURPOSE AND STRUCTURE OF THE MANUAL**

### **Purpose**

This Manual is intended for the use of staff employed in Internal Audit in the public sector in Montenegro.

Its purpose is to act as a common reference point for Internal Auditors, to assist in a common understanding of the principles of modern auditing techniques and terminology, and to assist them in carrying out their work.

The procedures and methodologies contained in the Manual comply with the International Standards for the Professional Practice of Internal Audit as set out by the international Institute of Internal Auditors (IIA), (January 2011). They have been adapted to make them relevant to the situation in the public sector in Montenegro.

To ensure that both the methodology and the procedures remain consistent with best practice and reflect changes in both the legal and audit environment, the Central Harmonisation Unit (CHU) in the Ministry of Finance is responsible for reviewing, and where necessary amending, the contents of the methodology and procedures. This review will be done annually or more frequently if needed.

Heads of Internal Audit are however asked to take a sensible view, and should be prepared to customise sections, where necessary, to suit their local circumstances. For example, to reflect specific organisational arrangements or types of systems within their own organisation. However any major changes should be discussed and agreed with the CHU in the Ministry of Finance.

It is each auditor's responsibility to ensure that all amendments to the methodology and procedures are understood and incorporated into the Manual.

The CHU in the Ministry of Finance will be pleased to consider suggestions from Heads of Internal audit for improvements to the processes and methodologies contained in the Manual

### **Structure**

The Manual comprises two parts:

- Part 1 – Internal Audit Standards, Policies and Planning which contains guidance on the key policy matters that affect the management and the work of IA
- Part 2 – Performing an Audit which explains the steps that have to be followed when carrying out an audit. It also provides guidance on report writing.

It is also intended to develop certain audit tools for some of the key financial systems, and these will be issued separately from the Manual.

Auditors are expected to apply the guidance and, where appropriate, the approaches and techniques set out in the Manual.

A glossary of the terms used in this Manual is provided at Appendix A to Part One of the Manual.

## 1. INTRODUCTION TO INTERNAL AUDIT IN THE PUBLIC SECTOR IN MONTENEGRO

### The purpose of internal audit

The Institute of Internal Auditors defines Internal Audit as follows:

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

IIA Inc - January 2011

Audit in the public sector adds value not just by analysing and reporting what has happened, but also by being forward looking, by identifying areas where improvements can be made and by encouraging good practice. In this way it helps to promote improved standards of governance, better management and decision-making, and a more effective use of the taxpayer's resources.

### Legal framework for Internal Audit

The principal legal framework for Internal Audit (IA) is the PIFC Law which states that IA:

'Will provide objective and expert opinion and advice on the adequacy of the financial management and control systems, with the objective of improving the way the entity operates.

Internal audit helps an entity in achieving its goals by applying a systematic and disciplined approach in evaluating the operation of the entity's operations. It does this by:

- Planning audit activities through the identification and assessment of the nature and level of risk related to each activity in the entity;
- Assessment of the adequacy and efficiency of the financial management and control system with respect to:
  - a) risk identification, assessment and management by the head of the entity;
  - b) compliance with laws and other regulations, operational guidelines, internal policies and contracts;
  - c) accurate, reliable, and complete financial and other operational information;
  - d) efficiency, effectiveness and economy of operations;
  - e) protection of resources and information, and
  - f) performance of tasks and achievement of goals;
- By giving recommendations to the entity for improvements to the financial management and control system.'

In addition the following decrees and regulations govern the work of IA:

- Decree on Establishing Internal Audit in the Public Sector (Official Gazette of Montenegro, No. 23/09);
- Decree on Titles of Internal Auditors (Official Gazette of Montenegro, No. 23/09), and
- Rulebook on the Manner and Procedure of Work of Internal Audit (Official Gazette of Montenegro, No. 32/09).



## Operational framework for the work of Internal Audit

IA operates in accordance with the Code of Ethics and the International Standards for the Professional Practice of Internal Auditing laid down by the Institute of Internal Auditors<sup>1</sup>. Together these set the framework for how internal auditors should behave and the way they should carry out their work. Further details can be obtained on the IIA website [www.theiia.org](http://www.theiia.org)

### Code of Ethics

The purpose of this Code of Ethics is to promote an ethical culture in the profession of internal audit. A code of ethics is necessary and appropriate for the profession of internal auditing, founded as it is on the trust placed in its objective assurance about risk management, control, and governance. It applies to all staff performing the duties of internal audit as set out in the PIFC Law. Any failures to comply with these ethical requirements could lead to disciplinary action being taken.

This Code of Ethics extends beyond the definition of internal auditing to include two essential components:

- Four key Principles that are relevant to the profession and practice of internal auditing;
- Rules of Conduct that describe behaviour norms expected of internal auditors in respect of each of those Principles. These rules are an aid to interpreting the Principles into practical applications and are intended to guide the ethical conduct of internal auditors.

### Principle 1 - Integrity

*The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgement.*

#### Rules of Conduct

Internal auditors:

- shall perform their work with honesty, diligence and responsibility.
- shall observe the law and make disclosures expected by the law and the profession.
- shall not knowingly be a party to any illegal activity, or engage in acts that are discreditable to the profession of internal auditing or to the organisation.
- shall respect and contribute to the legitimate and ethical objectives of the organisation.

### Principle 2 - Objectivity

*Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgements.*

#### Rules of Conduct

Internal auditors:

- shall not participate in any activity or relationship that may impair or be presumed to impair their unbiased assessment. This participation includes those activities or relationships that may be in conflict with the interests of the organisation.
- shall not accept anything that may impair or be presumed to impair their professional judgement.
- shall disclose all material facts known to them that, if not disclosed, may distort the reporting of activities under review.

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<sup>1</sup> The Code of Ethics and the Standards for the Professional Practice of Internal Auditing given in this Manual are based on those issued by the IIA in 2011.

### Principle 3 - Confidentiality

*Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.*

#### Rules of Conduct

Internal auditors:

- shall be prudent in the use and protection of information acquired in the course of their duties.
- shall not use information for any personal gain or in any manner that would be contrary to the law or detrimental to the legitimate and ethical objectives of the organisation.

### Principle 4 - Competency

*Internal auditors apply the knowledge, skills and experience needed in the performance of internal auditing services.*

#### Rules of Conduct

Internal auditors:

- shall engage only in those services for which they have the necessary knowledge, skills and experience.
- shall perform internal auditing services in accordance with the *International Standards for the Professional Practice of Internal Auditing*.
- shall continually improve their proficiency and the effectiveness and quality of their services.

#### *Internal Audit Standards*

The purpose of the Standards is to:

- set out basic principles that represent the practice of internal auditing as it should be;
- provide a framework for performing and promoting a broad range of internal audit activities which benefit and add value to the organisation;
- establish the basis for the evaluation of internal audit performance, and
- foster improved organisational processes and operations.

The Standards consist of Attribute Standards (the 1000 Series) and Performance Standards (the 2000 Series), and Implementation Standards. Details of each of the following standards can be seen in Appendix B to this Part of the Manual.

- a. **The Attribute Standards** address the characteristics of organisations and individuals performing internal audit activities. They are:
  - Standard 1000 – Purpose, Authority and Responsibility;
  - Standard 1100 – Independence and Objectivity;
  - Standard 1200 – Proficiency and Due Professional Care; and
  - Standard 1300 – Quality Assurance and Improvement Program.
- b. **The Performance Standards** describe the nature of internal audit activities and provide quality criteria against which the performance of these services can be measured. The Attribute and Performance Standards apply to internal audit services in general.
  - Standard 2000 – Managing the Internal Audit Activity;
  - Standard 2100 – Nature of Work;
  - Standard 2200 – Assignment Planning;
  - Standard 2300 – Performing the Assignment;
  - Standard 2400 – Communicating Results;
  - Standard 2500 – Monitoring Progress; and
  - Standard 2600 – Management's Acceptance of Risks.

It is compulsory for all members of Internal Audit (IA) to work in accordance with these Standards.

## 2. INTERNAL AUDIT CHARTER

### **1000 Purpose, Authority and Responsibility**

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

The PIFC Law (Articles 19 & 27) requires that every IA Unit should draft an Audit Charter, and discuss and agree it with the Head of the Organisation. This section sets out the purpose and content of an audit charter.

### **Purpose**

The purpose of the charter is to set out clearly the role of Internal Audit and to clarify the environment necessary for Internal Audit to function effectively and add value in an organisation. It also sets out the working relationships between Internal Audit and the organisation. The Audit Charter should:

- a. give an outline of the role of Internal Audit
- b. make reference to the scope of work of Internal Audit
- c. explain how the independence of IA is secured
- d. set out the responsibilities of the HIA and the Head of the organisation
- e. detail the reporting arrangements, and
- f. explain the relationship of IA to other review bodies – eg the Supreme Audit Institution.

The IA Charter should be reviewed on a regular basis and whenever major structural or other changes take place in the organisation.

As an interim measure, where IA Units have already agreed an IA Charter no immediate action needs to be taken to review that charter. However the HIA should review the content and operation of that Charter 12 months from the issue of the Audit Manual, taking into account the guidance provided in the manual and experience gained over that period.

An example of a possible IA Charter is set out below

### **The role of Internal Audit**

Internal Audit's role is to provide an assurance to the Head of the Organisation on the adequacy of the systems of internal control in that organisation. It helps an organisation achieve its objectives by carrying out a systematic assessment and evaluation of the risk management, control, and governance processes in order to:

- Determine whether acceptable policies and procedures are followed;
- Establish compliance with laws and regulations;
- Assess the risk management processes in the organisation;
- Appraise the economy, efficiency and effectiveness of operations;
- Determine that financial etc information is complete and accurate,
- Ensure assets are adequately safeguarded; and
- Ensure the accuracy, reliability, and timeliness of significant financial, managerial, and operating information.

### **Scope**

The scope of Internal Audit is unrestricted, and includes all programmes, activities, and processes. It also includes the audit of EU funds and any other funds and resources provided by other international bodies or institutions.

In carrying out its work Internal Audit is also concerned with the economy, efficiency, and effectiveness of activities. Its work can take the form of systems, performance/value for money, information technology audits and financial audits. It can also carry out consulting assignments, and these will usually be done at the request of management.

### **Independence**

In order to carry out its work effectively and to ensure that it is free to audit what it wants in the most appropriate way. It is essential that Internal Audit operates as an independent activity within the organisation.

To ensure this independence:

- The Head of Internal Audit reports direct to the Head of the Organisation;
- Internal Audit has the right of free and unrestricted access to all activities, all managers and their staff, records, property and electronic and other data;
- Plans its own work programmes – on the basis of a full risk assessment;
- The Head of Internal Audit has no line management responsibilities for any process or activity outside of Internal Audit;

## **Responsibilities of the Head of Internal Audit**

The Head of Internal Audit will:

- Develop a strategic plan of work for Internal Audit, which reflects the objectives and scope of Internal Audit, covers the full range of activities of the organisation and is based on an objective understanding and assessment of the risks facing the organisation. This strategic plan will be agreed with the Head of the Organisation;
- Develop an annual work plan for internal audit, based on the strategic plan, and taking into account the concerns of management in the organisation. This plan to be agreed with and approved by the Head of the Organisation;
- Ensure that all audits are carried out efficiently and effectively and that the annual work plans are achieved;
- Ensure that audit findings and conclusions are properly and promptly reported to management, and establish and maintain follow-up procedures to ensure that action is taken by management;
- Ensure that methodologies and other guidelines and requirements laid down by the CHU in the Ministry of Finance are applied appropriately and correctly; and
- Ensure that suitable staff are recruited for Internal Audit (see also Section 5, paragraph 2) and that they receive the training they need to carry out their duties effectively.

All of these responsibilities are to be carried out in compliance with the IIA Code of Ethics and International Professional Standards for Internal Auditing and the PIFC Law.

## **Responsibilities of the Head of the Organisation**

The Head of the Organisation will:

- Establish and maintain an internal audit unit;
- Ensure that Internal Audit has the resources (staff, facilities and equipment) it needs to fulfil its responsibilities;
- Ensure that Internal Audit is able to operate independently, particularly in respect of the rights of access and the reporting arrangements of the Head of Internal Audit;
- Ensure that Internal Audit recommendations are implemented; and

Send a copy of the annual report on Internal Audit activities to the Minister of Finance.

## **Reporting and Communication**

The Head of Internal Audit will be involved in the following key reporting and communication activities:

- Discussing and agreeing the strategic work plan (and annual updates of it) and the annual work plan with the Head of the Organisation and other members of senior management;
- Preparing quarterly/six monthly reports on Internal Audit activities and discussing them with the Head of the Organisation;
- Preparing and discussing an annual report for the Head of the Organisation on the activities of internal audit. The report should provide an assurance on the adequacy (or otherwise) of the systems of internal control;
- Ad hoc meetings with the Head of the Organisation to discuss serious issues arising from individual audits, suspected fraud, difficulties of access etc; and
- Attendance at the regular weekly management meeting. The precise arrangements will need to be discussed and agreed with the Head of the Organisation.

### **Relationship with the Supreme Audit Institution (SAI)**

The Head of Internal Audit shall:

- Maintain regular contact with the SAI Manager responsible for audits of the organisation. This will ensure co-ordination of work plans, discussion of areas of common concern and exchange of information on audit issues;
- Send a copy of all internal audit reports to the SAI once the report has been agreed with management, and
- Allow the SAI access to all Internal Audit reports, working papers, planning documents etc. and develop and maintain a relationship of trust and two-way co-operation between Internal Audit and the SAI.

Signed:

Head of Internal Audit

Head of Organisation

### 3. ROLE OF HEAD OF INTERNAL AUDIT

The Head of Internal Audit has a key role to play in the development of internal audit in his/her ministry. In particular it is important to overcome the misconceptions about what internal audit is here to do, and make it clear that it is not 'Inspection' by another name, but that it can play a positive and constructive part in the ministry.

The Head of Internal Audit should be regarded as a member of the management team in the ministry. This should involve regular attendance at management meetings so that he/she can keep informed about any planned developments and changes envisaged and be aware of any potential problems. The precise arrangements for achieving will vary between organisations, and they should be discussed and agreed with the Head of the Organisation and included in the Internal Audit Charter.

The precise responsibilities of the Head of Internal Audit are set out in Article 27 of the PIFC Law. This states that:

Internal audit unit head is responsible for carrying out planned internal audits and other activities of the internal audit unit, in particular:

- 1) Preparation and submission a draft internal audit charter to the head of the entity for approval,
- 2) Preparation and submission of the Strategic and annual internal audit plans for endorsement by the head of the entity;
- 3) Organization, coordination and distribution of work assignments to internal auditors in accordance with their knowledge and skills;
- 4) Approval the plans for individual audit;
- 5) Monitoring the implementation of annual internal audit plans and application of internal audit methodology based on international internal audit standards;
- 6) Monitoring of the implementation of internal audit recommendations;
- 7) Ensuring the professional and overall performance of internal audit.
- 8) Assessment of new financial management and control systems;
- 9) Preparation and submission for approval to the head of the entity of a plan for the continuous professional training and development of internal audit staff.

In addition the Head of Internal Audit unit should:

- Ensure the right conditions exist for audits to be carried out in an effective way and in accordance with the internal audit plan;
- manage and develop the internal audit function, by ensuring professional, technical and managerial support based on the International Internal Auditing Standards;
- develop strategic and annual work plans for internal audit unit, in cooperation with managers and on the basis of risk assessment;
- follow up recommendations, i.e. whether recommendations are implemented properly, efficiently and on time;
- develop procedures for carrying out internal audit activities;
- apply methods and guidelines issued by the Central Harmonization Unit;
- prepare annual and periodical reports for the head of the organisation on operations and audits carried out, and
- meet any obligations towards the Central Harmonization Unit arising from the PIFC Law and regulations adopted on the basis of this Law.

## 4. AUDIT PLANNING

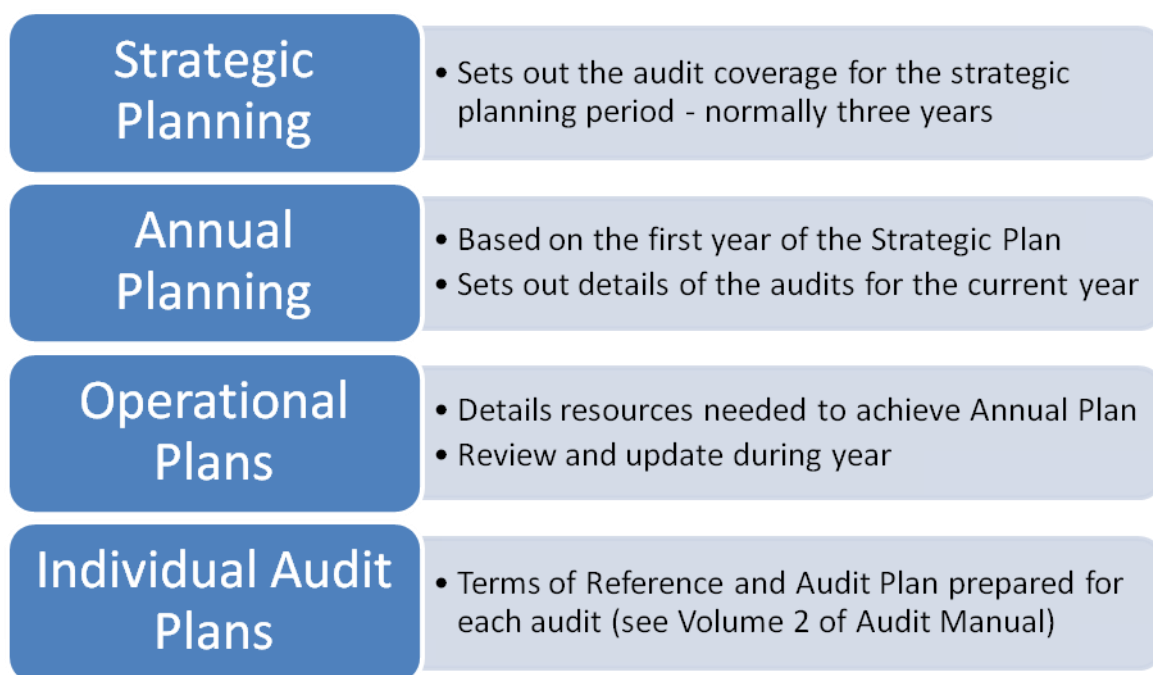
### 2010 Planning

The head of internal audit must establish risk-based plans to determine the priorities of the internal audit activity, consistent with the organisation's goals.

Audit planning is needed to enable Internal Audit (IA): to achieve its objectives; to establish its priorities and to ensure the efficient and effective use of audit resources. It also provides:

- a. a basis for the assessment of future resource requirements;
- b. authority to act once the plan is approved by senior management;
- c. a yardstick against which actual performance can be measured;
- d. a means of getting management 'buy-in' to the work of IA , and
- e. a permanent record of the factors considered and the judgements made when setting the plan.

Planning is a key part of the audit process and comprises four stages.



### 4.1 Strategic Planning

A good Strategic Plan will:

- a. Help to identify the 'audit universe' – ie all possible areas that should be subject to audit
- b. Provide an objective risk-based approach to defining IA's work
- c. Help IA to provide an assurance on systems of internal control, and
- d. Allow IA to optimize the use of its resources and improve its effectiveness as a service to management.



The IIA Standards require Audit Units to carry out risk-based planning and to review and update those plans annually.

The following are the stages involved in the preparation of a Strategic Plan:

- a. STEP 1 – Establish the audit environment
- b. STEP 2 - Identify all the auditable systems/areas
- c. STEP 3 - Carry out a risk assessment for each system/area
- d. STEP 4 - Decide on your audit strategy, and
- e. STEP 5 - Prepare an audit needs assessment.

In the early years of setting up IA it may be necessary to take a more pragmatic and less time-consuming approach to strategic planning, for example by grouping the auditable systems identified and/or by reducing the number of risk factors.

### **Step 1 - Establishing the Audit Environment**

The starting point for strategic planning is to have a good understanding of the context in which the organisation is operating.

This involves considering such things as:

- Management's attitude to control;
- Information about the general level of control in the organisation;
- The risk appetite of the organisation – is it very averse to risk or prepared to accept high levels of risk, and
- The willingness of management to accept and embrace change etc.

Based on this it is often worth trying to establish what your broad audit strategy might be. For example: what might be an appropriate period for the plan (e.g. 3 years or 5 years?) and what do you want to achieve over the period of the plan – possible objectives include 'raising awareness of risk management in the organisation; assisting the development of accountability in the organisation and encouraging the use of objectives by managers.

### **Step 2 - Identify auditable systems**

The next step is to identify what you are going to audit. Your objective should be to identify and define systems which cover all the objectives and activities of the organisation. Keep in mind that some systems will fully address a particular management objective(s) and others may only partially address an objective(s). It is useful to try to keep the number of systems or groups of systems to a manageable number.

You will need to find out about the organisation and the way it is structured. Areas of work by system or sub-system can be identified through consultation with different levels of management. Use should also be made of previous work done by IA and any other knowledge and experience gained by IA staff.

Other possible sources of information include:

- Management information, policy papers and laws which may provide details of aims, objectives and targets;
- contracts and service level agreements;

- organisational charts and systematisation schedules;
- the organisation's office directory;
- annual reports and performance targets;
- corporate plans, business plans, efficiency plans; and
- management accounts and budgets.

As well as identifying areas of work by system and sub-system you should:

- establish interfaces between systems;
- establish inter-departmental systems, and
- get management's opinion on which areas or particular factors are considered high risk.

By way of guidance the following are two common ways of classifying systems:

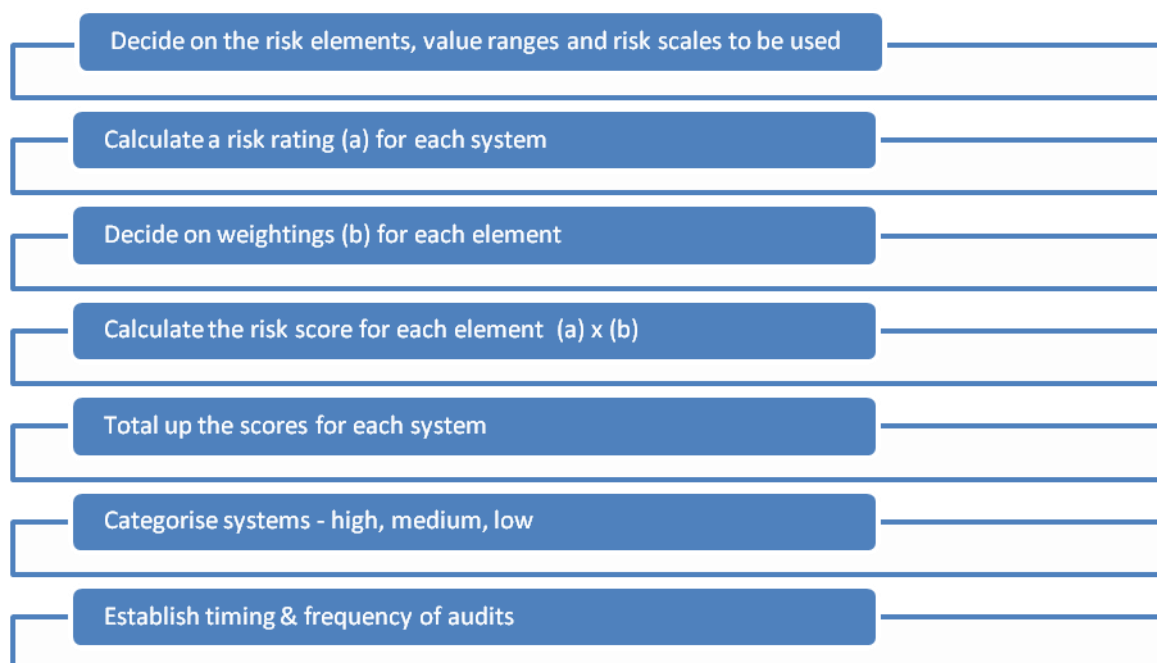
- a. *By function* – dividing systems into functional types which differ according to the part they play in the internal control system. Examples of these are:
  - Monitoring - information systems are likely to cover all parts of an organisation. They provide tools to a hierarchy of management. Potentially, work done on these systems can reduce the effort required to audit the systems at lower levels. If the organisation is relying on such systems as primary tools they should be priority systems in the audit plan
  - Operational - systems for carrying out the business of the organisation, including policy matters. The audit priority afforded to these systems will depend on their level and nature.
  - Service - administrative systems such as personnel, purchasing, marketing, finance, sales, office services, planning and accommodation cover many parts of an organisation. For the well known types of systems it may be convenient to adapt existing audit methodologies to the systems, thus saving development time. Although each system is unique at the detailed level, each system will often be based on a common pattern
- b. *Hierarchical*
  - Senior management will tend to view the organisation as sub-divided into a fairly small number of areas, approximately matching the organisation chart. These systems will have associated risks and may be linked to budget holder responsibilities and also to the organisation's critical success factors. If systems are analysed in this way, the links between systems will be particularly important. Systems are rarely confined to one part of the organisation and there are usually links and interrelationships between different parts of the organisation.

Regardless of the classification method used, the Head of Internal Audit needs to examine interfaces between systems within each institution to identify the extent to which the audit of one system can provide findings relevant to another system. Where one system acts as a control over another it may be possible to plan the audits in a more efficient way to take account of these links.

Whatever method is used to categorise systems, audit plans should still be based on a systems based audit approach. The objective is to plan a programme of audits which will provide evidence to support an assurance regarding the adequacy of the systems of management control. Value for Money and Performance Audits can be scheduled separately within the strategic plan, where appropriate.

### Step 3 - Risk assessment of the areas identified

Once all systems have been identified, an assessment of risk needs to be done. This provides a rationale for the direction of audit resources over the long term. The purpose of this is to focus audits on those activities which carry greater risk for the organisation as a whole. The process of risk assessment involves the following main steps:



Risks can often be determined through interviews with managers and staff; use of questionnaires and group discussions between auditors. The amount of research undertaken should be influenced by the cost and degree of difficulty in collecting data for the assessment of systems. The following are common risk categories that can be used to help identify risks:

- Reputational risk - arising from adverse publicity and exposure;
- Operational risk - affecting the relationship between service and general public e.g. disruption to service;
- Strategic risk - affecting the organisation in the long term;
- Legal risk - arising from legislation;
- Social risk - arising from changes in demographic, residential or socio-economic trends;
- Contractual risk - relating to the failure to deliver goods/services at the agreed cost & specification;
- Financial risk - risks that have a purely financial base;
- Managerial risk - relating to the day to day responsibility and accountability of staff;
- Property risk - relating to theft, deterioration etc. ;
- Regularity risk - relating to legal action, external inspection etc. ;
- Technological risk - relating to the capacity to manage and harness technological change;
- Professional risk - relating to particular professions e.g. protection, duty of care;
- Specific risk - such as health & safety;
- Natural risk - flood, fire, earthquake etc. ; and
- Governance risk - relating to the government's objectives and the roles and responsibilities of ministers.

Risk assessment is based essentially on subjective judgement but various techniques can be used to make the analysis more systematic and, to some extent, more objective. Use of them will strongly support the auditor's judgement on the priority and frequency of audits. They can also help to identify areas of high exposure which might not otherwise have been identified. Each stage of the risk assessment exercise should be fully documented.

One commonly used approach to the assessment of priorities and frequencies involves the calculation of risk indices. It combines determining a risk rating for each of a number of pre-determined characteristics or elements of a system and assigning weights to each of them, thereby incorporating a judgement of their relative importance - on a scale of 1(low) to 5(high) risk. This enables the calculation of a risk index for each system. Some typical risk elements include:

- Value of transactions,
- Volume of transactions,
- Value of income,
- Value of expenditure,
- Asset value and liquidity,
- Systems characteristics,
- Organisational factors - number of staff, supervisor to staff ratio, staff turnover etc,
- Complexity of the system,
- Distance from the centre,
- Stability of the system - tendency to or likelihood of change,
- Special elements unique to the system,
- Sensitivity of the system - e.g. political sensitivity, general public, pressure groups,
- Scope and effect of the system,
- Effect of system on future events and decision making,
- Effect of system on other systems,
- Management and control,
- Staff morale - speed of staff turnover,
- Quality of internal control within the system,
- Amount of control over the system exerted by other systems,
- Date and findings of the last audit, and
- Opinion expressed by other review bodies (e.g. external audit, inspection).

It is necessary to decide which risk elements you are going to apply, since the same ones will be used to determine the risk rating for each system. An example of some typical risk elements and their values is given in the table below:

<b>Risk element</b>	<b>Value range</b>	<b>Risk rating</b>
Staff Numbers	≤ 100	1
	≤ 500	2
	≤ 1000	3
	≤ 10000	4
	> 10000	5
Direct expenditure (excluding procurement)	≤ 5,000 Euros	1
	≤ 20,000 Euros	2
	≤ 50,000 Euros	3
	≤ 100,000 Euros	4
	> 100,000 Euros	5
Value of transactions/procurement	≤ 5,000 Euros	1
	≤ 20,000 Euros	2
	≤ 50,000 Euros	3
	≤ 100,000 Euros	4
	> 100,000 Euros	5
'Sensitivity of activities'	Scale of Low to High	Scale of 1-5
		1 5
Geographical spread	Fully centralised	1
	Partially centralised	3
	Considerable centralisation	5

These risk ratings for each element cannot be used as they stand. They need to be weighted to reflect your assessment of the relative significance of the different elements. In allocating weights, you need to judge between the relative significance of different elements. For example, the degree of stability of the system may be more important than the volume of transactions because systems which change may have new and unproven internal controls. Organisational elements such as the effect of one system on another or on a range of sub-systems might be weighted higher than elements which apply only to the system in question. Similarly, systems which have far-reaching effects on future decisions e.g. forecasting or research and development might be weighted higher than systems whose effect is more immediate.

The elements and weighting factors should be combined into a formula which can be used to calculate the risk index. In choosing weighting factors, the auditor must avoid introducing unfair bias into the formula. That formula should be checked to ensure that small variations in the elements and weighting factors do not lead to significant changes to the order of priority or frequency, particularly where subjective judgement is required.

The weighting system should be kept as simple as possible, and often a scale of one to five is used. An example of how this might be applied in practice is shown below.

### Calculation of risk indices

	System 1			System 2			System 3			System 4		
Risk factors	Rating	Weighting	Total	Rating	Weighting	Total	Rating	Weighting	Total	Rating	Weighting	Total
Total Spend	2	5	10	5	5	25	5	5	25	3	5	15
Volume of transactions	5	2	10	5	2	10	5	2	10	1	2	2
Stuff Numbers	3	3	9	3	3	9	3	3	9	2	3	6
Direct expenditure (less procurement)	2	4	8	5	4	20	2	4	8	3	4	12
Procurement	3	5	15	5	5	25	2	5	10	5	5	25
"Sensitivity" of activities	3	3	9	2	3	6	2	3	6	4	3	12
Geographical Spread	3	4	12	5	4	20	5	4	20	3	4	12
Managerial "approach"	5	3	15	5	3	15	5	3	15	5	3	15
<b>Risk Index</b>	<b>88</b>			<b>130</b>			<b>103</b>			<b>99</b>		

#### Step 4 - Audit strategy

Once the systems have been defined and the risk indices calculated the Head of Internal Audit should discuss and agree the results with management.

Once this has been done the audit strategy needs to be defined. The broad audit strategy defined earlier in the process should provide a good starting point for this. It is not realistic, or necessary to cover all aspects of the internal control system in detail every year. The objective of the strategy should be to provide sufficient coverage of the main areas to allow an overall opinion to be given on the adequacy of the systems of control.

Based on the risk indices you will need to categorise the audit systems into high, medium and low risk. For example, you could decide:

- a. Audits with a risk index of 85 are high risk;
- b. Audits with a risk index of 40 – 84 are medium risk, and
- c. Audits with a risk index of 39 or less are low risk.

The audit strategy should involve auditing higher risk systems more frequently – usually every year – in order to confirm that these vitally important systems are under effective control. On the first audit of a high risk system, controls will be reviewed down to a detailed level in order to establish which controls are the key ones and how effective they are. Subsequent audits of high risk systems will be limited to confirming that the system objectives, control objectives, risks and controls remain the same and carrying out compliance tests on the key controls.

Medium risk systems may be audited less frequently. If the audit cycle is three years then these systems could be subject to some audit work two out of the three years of the cycle. This may be justified partly because not auditing them in any one year leaves a relatively small exposure.

Low risk systems could be audited only once every three years – and in some cases that audit could be restricted to two or three of the key systems.

The first time a strategic plan is prepared it will probably be necessary to assign standard times to each category of audit, eg:

- i. High Risk Score – 40 days per annum (i.e. 120 days per system over the cycle)
- ii. Medium Risk Score – 25 days (i.e. 75 days per cycle)
- iii. Low Risk Score – 25 days per audit cycle.

In later updates of the strategic plan these figures can be refined and specific times allocated to audits as more experience is gained.

This will enable you to calculate the number of auditor days needed for each year of the strategic plan. The medium and low risk audits should be distributed evenly over the period of the strategic plan.

To this figure you need to add:

- time in each year for the audit of systems under development. Where large new systems developments are taking place or due to start, audit planning can be more precise and should take account of predicted timescales for the developments. There will normally be key stages in the development of a new system at which different types of audit activity will be required, depending upon the project development methodology used. It will be necessary to estimate at which points audit input (time) will be needed and to build blocks of time into the audit plan to cover these periods.

- time in each year for other work such as specific follow-ups, performance audit, advice and fraud investigation. Finally, a 'contingency' (typically 10 - 15%) should be added to allow for unplanned events that may require audit input – eg management requests, an unforeseen restructuring of the organisation or an expansion of the organisation's responsibilities.

This will give you a grand total of time needed to carry out audits in each year of the audit cycle.

## **Step 5 - Assessment of audit need**

The next stage is to determine the resource (staff) requirements - the audit needs assessment. Estimates of staff time by auditor grade for each audit assignment should be made. Initially, the audit needs of an organisation should be determined without regard to constraints such as the time and resources which may be available.

Ideally, these estimates should be based on anticipated performance and competence of audit staff. Untrained or inexperienced staff will take longer to perform tasks. The total staff time inputs should include basic direct time and any time inputs by the Head of Internal Audit. Basic direct time includes all stages of an audit such as collecting background data, preparing the audit plan, fact finding, documenting, testing, preparing reports, discussing audit findings, immediate follow up and monitoring of systems changes. It should be analysed to reflect the need for specialist skills (such as computer auditors, accountants etc) and to show where the audit requires the expertise of a more experienced auditor.

In practice a simple way to do this in the early days of setting up IA is to calculate the number of audit days available using your existing audit staff. In deciding the number of days available for each auditor you should subtract the following from the total of 260 available working days per auditor per year:

- Annual leave
- Public holidays
- Training (remembering that higher levels of training will be needed in the early years, or if there are a large number of relatively new staff)
- Sickness
- Admin (typically 15 days per annum)

This will give you the net days available for each auditor, and this should be totaled. To this total should be added the number of direct days per audit which the HIA is expected to contribute (say between 3 and 5) to give a grand total of days available. This grand total should be compared with the number of days needed, enabling the HIA to determine whether he/she has enough staff, and if not how many additional staff are needed to achieve a level of coverage that will enable a reasonable level of audit assurance to be provided.

If additional resources are required (which will often be the case) the HIA will have to discuss this with the Head of the Organisation to decide whether the necessary extra audit staff can be made available. If it is only possible to provide a limited number of additional staff (or no additional staff) the Head of Internal Audit will need to discuss and agree the level of assurance that can be provided, and where the resources of IA should be focused. Throughout the planning process you need to keep in mind that it will never be possible to provide total assurance

Following these discussions a revised strategic plan should be prepared showing:

- resources - the resources expected to be available each year. This will take account of specific skill requirements and a preference for smoothing out peaks and troughs
- the audits to be carried out - annual tasks identified in the needs assessment will be the first charge against each year's available resources



- contingency - there should be a contingency element in each year of the plan consistent with the overall contingency in the needs assessment
- priority - as a general rule systems with the highest priority should be scheduled as early as possible in the timetable within the available annual resources
- frequency - has already been considered in the needs assessment and determines how often a system should be audited
- centralised systems - the approach should reflect the extent to which systems are centrally prescribed or fall within delegated authority limits. This applies particularly in the case of a network of offices operating a common system. Audit visits may be necessary only to test the broad control arrangements in place
- logistics - there may be good reasons why certain audits should be done (or should not be done) within a short time of each other. There may also be certain audits which require specialist staff and the allocation of these to any year should be consistent with the specialist staff available in it. This factor becomes more critical in annual plans

### **Other factors to consider once the IA unit is properly staffed**

The need to plan for the audit of systems under development. It may be necessary to build a contingency into the plan for this. Where there are major known developments planning can be more precise and should take account of predicted timescales. There will normally be key stages at which different types of audit activity will be required. Knowledge of the project development methodology used will allow estimates to be made of the stage at which the greatest amount of audit time will be required and blocks of work built into the audit plan

Similarly, it is necessary to allow time for other work such as specific follow-ups, performance audit, advice to management and fraud investigation. Finally, a 'contingency' (typically 10 – 15%) may be included to allow for unplanned events – e.g. an unforeseen restructuring of the organisation or an expansion of the organisation's responsibilities, which may require audit input.

The strategic plan should be reviewed and updated annually, with the second year of the current strategic plan becoming the first year of the new plan and also the basis of annual plan for the forthcoming year. A full re-assessment should take place every four to five years – or sooner if major changes occur within the organisation.

### **Presenting the Annual Plan to the Head of the Organisation and Senior Management**

The plan should:

- Identify clearly the main objectives of the entity and the main policy instruments through which these objectives are to meet.
- Identify the major risks to the achievement of high-level objective.
- Explain (briefly) how the areas to be audited have been determined and how individual systems grouped for audit purposes.
- Explain how risks have been assessed and systems etc ranked for audit.
- Identify the frequency of coverage for high medium and low risk systems/audit missions, and explain that the aim is normally not to cover all aspects of the internal control system in detail every year, but to obtain sufficient coverage of the main areas to allow a general opinion to be formed
- Identify the resources required and those available to implement the strategy, drawing attention to the impact of resource shortfalls.
- Provide the annual work plan for the first year of the strategy.
- Explain the arrangements for accommodating additional (ad hoc) audit missions and how these can be accommodated within the annual work plan.
- Comment generally on the quality and effectiveness of the audit resources available and the staff training needs.

## **4.2 The Annual Plan**

The annual plan, which is developed from the strategic plan, is prepared on an annual basis, and must be approved by the Head of the Organisation. It is based on the first year of the strategic plan and should provide additional detail, for example defining the tasks to be performed and identifying critical areas, setting target dates and allocating resources for the forthcoming year.

It must take account of any new developments. For example:

- have there been any changes in the organisation's activities which have not been reflected in the strategic plan?
- is the original assessment of risk and priority still appropriate?
- are the staff available now and are they more or less experienced than anticipated?
- has there been any slippage in previous annual plans which must now be rescheduled, either into this annual plan or the strategic plan?

The following stages are involved in drawing up the annual plan:

- Establishing the staff and other resources available over the planning period. This involves identifying known absences, expected changes in staff and other commitments;
- based on the re-appraisal above, select the appropriate audits from the strategic plan, consistent with the balance of available resource;
- identify the man days, in direct time, needed for each audit; and
- schedule the audits by months/quarters - ensuring that there are no inconsistencies. It is important to consider whether any audits must or must not be done at specific times.

The Head of Internal Audit should consider the strengths and weaknesses of the staff available and allow for the need to develop and train his or her staff. Team Leaders may be responsible for specific blocks of audits - either by function, location or programme. In such circumstances, the preparation of parts of the annual plan may be delegated to them but the Head of Internal Audit remains responsible for the overall coordination and consistency of the plan.

### **Operational Plans**

The operational plan sets out the precise allocation of resources to specific audits and is an important management tool for the Head of Internal Audit. Progress against the plan (and against the overall annual plan) should be reviewed at least monthly to identify any shortfalls and to decide on the corrective action to be taken.

### **Assignment Plans**

Detailed guidance on preparing assignment plans for individual audits is given in Volume Two of this Manual.

## 5. STAFFING POLICIES

### 2030 RESOURCE MANAGEMENT

The head of internal audit must ensure that internal audit resources are appropriate, sufficient and effectively deployed to achieve the approved plan.

Having good staff is key to the success of internal audit. That is why particular emphasis is given to recruiting high calibre people and to training and developing them. The HIA should discuss and agree internal audit recruitment and training needs with the head of the organisation. This section sets out the main policies relating to staff management.

### Selection

The HIA is responsible for ensuring that the staff appointed to Internal Audit have the necessary background and personal attributes to work effectively in IA and that they have, or will be able to acquire, the knowledge and skills needed to carry out the work of IA. In order to do this the HIA will need to be actively involved in the selection of audit staff. The way in which this will be achieved should be discussed and agreed with the head of the organisation and the person responsible for human resources. This procedure should be referred to in the IA Charter.

The minimum requirement is a first degree. This will often be in Law, Economics, Management or some other relevant discipline. However, applicants with degrees in other subjects should also be considered, because it is important to have a wide range of knowledge and a variety of different approaches and attitudes amongst IA staff.

When recruiting staff the HIA also needs to try to ensure that the unit as a whole has the experience necessary to audit the wide range of activities in which most organisations are involved. These include: management; administration; organisational issues; security; IT and information systems. In practice it will be very difficult to achieve this, but it is an objective which the HIA should always have in mind.

Equally important as educational achievement and experience are personal attributes and skills. These include:

- The analytical skills to understand and appraise systems and controls quickly and to make sound judgements;
- The determination to follow investigations through to their logical conclusions, but also to use judgement to decide when unproductive lines of enquiry should be dropped;
- An imaginative approach to work;
- Being capable of gaining the respect and co-operation of auditees and colleagues;
- Being able to communicate orally and in writing in a tactful and convincing manner and to argue their conclusions to senior levels if necessary;
- Being able to 'stand their ground' and argue the case effectively;
- Negotiating skills;
- The ability to solve problems and come up with practical solutions;
- Tact and diplomacy, and
- Personal integrity.

In the early stages of development of Internal Audit in Montenegro few, if any, candidates for posts in Internal Audit will not have prior audit experience. In such cases it will be essential to establish

whether or not candidates have the personal and interpersonal skills needed for them to become effective internal auditors.

In some cases it may be appropriate to employ specialist staff such as surveyors, engineers, lawyers or statisticians for a specific audit, or on a short term basis to provide particular expertise for particular audits. The HIA is responsible for ensuring that such specialists receive the audit training they need to do their job effectively.

The HIA is responsible for preparing and keeping up to date Job Descriptions for each audit post including his/her own.

## **5.1 Training**

The service provided by IA audit should meet the highest professional standards and satisfy the expectations of the organisation. If auditors are to achieve these requirements, they must receive appropriate training. The HIA must ensure that:

- The training requirements of internal audit are identified, co-ordinated and kept under review;
- Adequate training programmes are available for all internal audit staff, and
- Internal auditors do actually receive appropriate tuition and the practical experience necessary to enable them to carry out their work effectively.

Internal Audit also supports training of a general career development nature within the framework of the organisation's policy and the training resources and facilities available.

Given the wide range of skills and knowledge required by internal auditors, training should be provided on a planned and continuous basis and cover the following areas:

- Knowledge of the way Government works, in order to place internal audit in context within the organisation;
- Knowledge and understanding of fundamental audit principles and practices which all auditors should possess;
- Training in accounting principles and the accounting arrangements adopted within the organisation and government;
- Training in audit skills and techniques;
- Personal development training, including inter-personal skills, in order to improve the effectiveness of auditors and team leaders;
- Specialised training for those auditors responsible for a particular activity, such as computer audit, which requires special skills or knowledge; and
- Management training, both for auditors who have the potential to manage and direct and for existing team leaders to improve their effectiveness.

Training can often be unstructured and ad hoc, more in response to courses on offer, rather than to specific training needs that have been identified. To ensure the best value from training, it is essential to have a training strategy. One point must be clearly understood however: merely providing the training does not of itself improve the competence of staff — the training must be underpinned by practical experience and by applying and developing new skills or knowledge at work.

## Training strategy and plan

In developing the training plan and strategy, the HIA will consider:

- The audit work strategy;
- The annual audit Plan;
- The outcome of current skills/staff development interviews ;
- Gaps in current skills levels identified using the skills matrix;
- The individual objectives of each member of staff and their need for continuing professional development;
- Relevant legislation and internal standards;
- The training budget;
- Sources of training;
- The organisation's training strategy and
- Any project and specialist work to be undertaken.

The training strategy should encompass all the training needs of Internal Audit and take account of any specific requirements arising from the annual work plans. It involves:

- *Defining the skills required for each audit grade* - this involves analysing what staff at each audit grade need to know and need to be able to do to perform competently the job required;
- *Identifying the training need* - having established the skills required the next stage is to compare these with the skills in place and thus identify what training is needed in order to address any shortfall;
- *Considering ways of providing the training* - the type and quality of training that can be provided depends largely on the budget available. There are many alternative means of meeting training needs including:
  - Professional training;
  - Staff induction courses;
  - External and internal courses;
  - Structured feedback by those attending formal training courses, including distribution of course handouts etc;
  - Mentoring;
  - Secondments ;
  - Setting up an audit technical library; and
  - Distribution of copies of current articles, etc covering audit practice.
- *Establishing the training budget* - once the training need and potential sources of training are known, it is essential to relate them to the funds available. If the existing training budget is insufficient the HIA should prepare a case to support an appeal for additional funding, or at least re-evaluate the way in which the current budget is being spent.

Based on this training strategy the HIA will prepare an annual training plan. Its purpose is to ensure that staff receive the training and practical experience they need to enable them to carry out their audit duties effectively. This plan will divide the training activities to be undertaken by individual staff members into a number of training categories (e.g. management skills, information technology, audit techniques, and professional development).

Finally the training program needs to be managed. This should be done in conjunction with CHU and will involve a number of tasks including:

- Identifying suitable training providers to meet training needs;

- Controlling the training budget;
- Monitoring the quality and effectiveness of the training provided;
- Updating the training strategy; and
- Ensuring training requirements are reviewed regularly.

## **5.2 Career development**

In the longer term the HIA should also consider the career development needs of each member of the audit team. This includes both development within IAU and development for positions in other sectors and units. This is essential if staff are to be motivated and retained in IAU. To assist in this each person in IAU will keep records of their individual training plans and achievements, and this will be reviewed annually with the HIA.

The individual auditor's training plan should also take into account their aspirations and career development needs. This could include exposure to new:

- Audit areas;
- Audit methodologies;
- Supervisory and managerial roles;
- Research and development work, and
- Attachments of internal auditors either within or outside the organisation, and to audit and non-audit posts.

It is widely recognized that working within internal audit is an effective training ground for general career development within an organisation. The opportunity for the secondment of suitable staff into Internal Audit should be encouraged, providing the person seconded with a broad overview of the organisation, and providing additional resources to IA.

### **Continuing professional development**

Internal auditors are responsible for continuing their professional education in order to maintain their proficiency. They should keep themselves informed about improvements and current developments in internal auditing, and maintain records of all developmental activities.

## 6. EXTERNAL RELATIONSHIPS

### 2050 COORDINATION

The head of internal audit must share information and coordinate activities with other internal and external providers of assurance and consulting services to ensure proper coverage and minimise duplication of efforts.

Relationships with management, staff, external auditors, and other review agencies must be centred on the need for mutual confidence, understanding of the role of Internal Audit and cooperation. Management and staff at all levels must have complete confidence in the integrity, independence, and capability of Internal Audit. This should be reflected and maintained in good working relationships between auditors and auditees.

### Relationships with management

#### General liaison

The HIA is responsible for consulting with management of the organisation in preparing and updating the Audit Needs Assessment, the Audit Strategy and the Annual Audit Plan.

The HIA should maintain regular contact with senior management in the organisation, by means of regular meetings and six monthly reports on Internal Audit activities.

As a general rule all audit staff are encouraged to make contact with line management at the appropriate level during the course of planning and conducting an audit assignment. Unless the HIA decides otherwise, Auditors should normally feel free to contact staff up to Head of Department or equivalent level in the course of their work. Above that level, the HIA should be consulted beforehand.

The HIA should maintain contact with Heads Department in respect of:

- Discussion and review of assignments which it is proposed to include in the Annual Audit Plan, before the program is finalized by the HIA;
- Keeping abreast of organisational and systems developments in the organisation, and
- Gaining a fuller understanding of the operational problems facing Heads of Department in order to help identify areas of potential audit interest.
- Making the arrangements to set up individual audit assignments. This will involve:
  - Notifying management of any pre-audit planning work which is to be undertaken;
  - Discussing audit terms of reference with the client and confirming them in writing;
  - Providing, where necessary, periodic oral progress reports to the client, and
  - Holding an exit meeting with the client to discuss audit findings, conclusions, and potential recommendations.

#### Requests by management for advice and guidance

Internal Audit staff will be approached for advice on a wide range of matters, often on an informal basis. Whilst it is important that Internal Audit should be seen to be responsive and helpful to such requests, it should not be done in a way that may jeopardize the independence and objectivity of Internal Audit. Staff must exercise professional judgement and caution to avoid giving the impression that Internal Audit is participating in the client's decision process.

When dealing with ad hoc requests for advice and guidance:

- Internal Audit staff must promptly inform their HIA of any request by management;
- Written guidance should only be given by the HIA;
- If oral advice is given on the spot by an auditor it is important to make it clear that it is purely informal advice, and should not be taken to reflect Internal Audit's official view on the matter.

### **Relationship with the Supreme Audit Institution**

The principal role of the Supreme Audit Institution (SAI) is to express an opinion on whether the Government's financial statements present a fair view of its financial position, and whether they conform to generally accepted government accounting principles and International Accounting Standards (where appropriate). As such, their objectives differ substantially from those of Internal Audit, although certain areas of common interest exist. Internal Audit does not act on behalf of the SAI, although the SAI may decide to rely on some of the work done by internal audit. .

The HIA will hold regular quarterly meetings with the SAI manager responsible for the organisation. The objective of these meetings is to develop cooperation with the external auditors, thereby ensuring that the organisation is provided with a comprehensive audit service and minimize duplication of effort. These contacts will involve:

- Discussion of work programs;
  - Exchanging copies of reports;
  - Allowing access to audit files; and
  - Holding regular liaison meetings.
1. The draft Internal Audit Annual Plan for the next financial year should be discussed with SAI before the plan is sent to the minister/head of the organisation for approval.
  2. Copies of all Internal Audit reports should be sent to SAI when the final version is agreed and issued.

#### *Access to files*

Internal Audit will make its audit files available to external audit on request.

### **Relationship with CHU**

The Head of Internal should maintain regular contact with CHU and see them as a potential source of guidance and advice on all matters relating to internal audit.

The Head of Internal Audit is required to prepare an annual report on the actual audits completed and other matters relating to the development and management of internal audit. The structure and content of that report will be specified by CHU.

The annual report has to be approved by the Head of the Organisation prior to being submitted to CHU by the end of January in the following year.



## 7. QUALITY ASSURANCE POLICIES

### **1300 Quality Assurance and Improvement Programme**

The head of internal audit must develop and maintain a quality assurance and improvement programme that covers all aspects of the internal audit activity.

### **1310 Requirements of the Quality Assurance and Improvement Programme**

The quality assurance and improvement programme must include both internal and external assessments.

The IIA Standards stress the importance of quality and continuous improvement in internal audit. It is the HIA's responsibility to develop and maintain a quality assurance (QA) programme that covers all aspects of the internal audit activity and continuously monitors its effectiveness. This involves defining the appropriate standards and level of quality for audit outputs and then establishing comprehensive procedures which will ensure that this level of quality is achieved and maintained.

QA takes place at two levels:

- Level One involves internal assessments to ensure that individual audits are carried out to an acceptable level of quality; and
- Level Two involves broader external reviews of the full range of audit tasks to establish that laid down policies and procedures are adhered to and that they actually do ensure that work is carried out to an acceptable level of quality.

### **Internal assessments**

Each audit needs to be supervised and reviewed in order to ensure that the quality of audit work is maintained and that the coverage and timing of the audit is in line with the audit plan. The HIA is responsible for ensuring that individual audits are adequately resourced and properly supervised throughout and should review each audit on an ongoing basis. The specific arrangements for supervising and reviewing individual audits are set out in Part Two of the Audit Manual.

### **External QA reviews**

In addition to assessing the quality of individual audits it is important to obtain independent assurance that the internal audit policies and procedures for carrying out audits are being adhered to and that they are achieving their objectives. It is also important to obtain assurance about the processes for the way the internal audit function is being managed.

Whilst the IIA recommend that an external quality review should be carried out at least once every five years, this is unlikely to be practical in Montenegro in the medium term. In the meantime it is suggested that such reviews could be done by:

- The CHU in the Ministry of Finance
- The SAI, or
- The HIA of another IA unit.

It is important that these reviews are carried out in a way which is consistent with the guidance set out in the IIA Quality Assurance Manual.

In the longer term, when internal audit in Montenegro is more established, it may be possible for a review to be conducted by a reviewer or a review team from outside of the public sector.

## 8. FRAUD POLICY

### Introduction

Fraud can be defined as theft with deception. It includes bribery, extortion, forgery, theft, conspiracy, false representation, misappropriation, and concealment of material facts. It may involve either direct gain (e.g. money or property) or indirect gains such as power, influence, promotion, or bonuses.

There are three basic types of fraud:

- *Corruption*, which involves offering, giving, soliciting or accepting an inducement or reward that may influence the action of any person. It can take the form of outside;
- Pressures or of collusion between staff and third parties;
- *Employee fraud*, which is committed by an employee against the organisation to the direct benefit of the employee or, due to the position they hold, committed against a third party; and
- *External fraud*, which is committed by an outsider (either with or without internal help) via the deliberate misinterpretation of information for gain, or by recognising and exploiting weaknesses in systems.

There are two main groups of factors that can allow fraud to occur - operational and personal. Examples of these factors are:

- *Operational factors*
  - A weak control environment;
  - Staff being asked to carry out duties which exceed their capabilities; and
  - Staff shortages at management level
- *Personal factors*
  - Personal financial difficulties;
  - Personal character traits; and
  - Pressure being exerted on an employee by a third party.

For fraud to occur there must be:

- The means – e.g. knowledge of the job/systems in operation;
- The motive – e.g. the employee has large personal debts or other financial problems; and
- The opportunity - in the form of operational or control weaknesses.

### Responsibilities for safeguarding against fraud and corruption

#### Management

The responsibility for safeguarding an organisation from fraud and corruption lies with the management of that organisation. They should do this by introducing and maintaining a comprehensive system of internal controls.

#### Internal Audit

The responsibilities of IA in relation to fraud are set out in Article 29 of the PIFC Law, which makes it clear that any case of suspected fraud should be notified immediately, in writing, to the head of

the organisation. However, IA is **not** responsible for identifying fraud and corruption, but to help management to ensure that the procedures and systems of internal control they have management minimise the risk of fraud and corruption taking place without detection.

Internal Audit should consider the risk of fraud and corruption when preparing strategic plans and planning individual audits. Likely high risk systems include:

- The handling of cash;
- Assets and stores;
- awarding contracts;
- Receipt of funds from outside the organisation;
- Payments of all kinds by the organisation ;
- Travel claims; and
- Wages and salaries.

When doing an audit the systems should be tested to ensure that the risk of fraud, both internal and external, is minimized and auditors should be alert to any control weaknesses which could allow fraud to occur. If significant control weaknesses are discovered auditors should test to identify whether the weakness has been exploited.

Where sufficient indicators of fraud emerge to justify an investigation the auditor must put the evidence in a safe place and inform the HIA immediately. The HIA will decide how the matter should be handled. Under no circumstances should any aspect of the case be discussed with client management or staff without the prior approval of the HIA.

### **Investigating fraud**

The prime responsibility for conducting fraud and corruption investigations rests with management. Where fraud is suspected in connection with the use of EU Funds there are set procedures that must be followed for reporting and handling those cases.

### **Some examples of fraudulent activities**

These include:

- Officials taking percentages on government contracts, which are often paid into foreign bank accounts;
- Officials receiving excessive 'hospitality' from government contractors, and benefits in kind, such as scholarships for the education of children at foreign universities;
- Officials contracting government business to themselves, either through front companies and 'partners', other family members or even openly to themselves as 'consultants';
- Officials deliberately travelling abroad so that they can claim per diem allowances which they themselves set at extravagant levels;
- Revenue officials practicing extortion by threatening to surcharge taxpayers or importers unless bribes are paid – resulting in unjustifiably low assessments being made or goods being passed for importation without payment of any duty at all; and
- Providers of public services (e.g. drivers' licences, passport control, visas etc) insisting on payments for the services or to speed up the process/prevent delays.

### 1.1.1

#### **Some indicators that fraud may be taking place**

Where a member of staff:

- Is responsible for two or more of the following activities: ordering, receipt of goods or services and approval for payment;
- Fails to take annual leave;
- Tends to take leave only a few days at a time or in odd days, here and there thus minimising time away from the office;
- Is unwilling to delegate;
- Is secretive/evasive about particular contracts and/or suppliers;
- Refuses to let anyone else deal with a particular contractor/supplier;
- Is generally reluctant to discuss what he or she is doing (may answer audit questions with unreasonable explanations or become annoyed at reasonable questions) ;
- Never wants to change job;
- Tends to take on too much;
- Never has time to talk to their manager or their immediate supervisor;
- Regularly works at the weekend;
- Makes other staff unwilling or unable to relax in their company;
- Attempts to gather too much power and influence ; and
- Displays evidence of an extravagant lifestyle (second house; luxury cars; expensive clothing; expensive vacations; regularly dining out at expensive restaurants etc).

All of these should be seen as no more than indicators that something may not be quite right. Considerable caution needs to be exercised in following them up.

## 9. OVERVIEWS OF THE MAIN TYPES OF AUDIT

The PIFC Law (Article 17) sets out the main types of audit that may be carried out by internal audit. These are as follows:

- Systems audit;
- Compliance audit;
- Performance audit;
- Financial audit;
- Information technology audit.

This section provides a brief explanation of each of these types of audit.

### Systems Audit

Systems Audit is the structured analysis and evaluation of the extent to which systems of internal control ensure that objectives of each organisation will be achieved. It is used extensively in internal audit and the approach to systems audit work is set out in detail in Part 2 of this Audit Manual.

Systems audit involves:

- Analysing the organisation's systems in an assessment of audit need. This enables internal auditors to see systems in the proper perspective of:
  - Their relative risk and materiality to the organisation;
  - Which parts of the organisation they impact upon; and
  - The relationships between different systems.
- Assessing how internal controls are operating within a system, so that a view can be formed on whether reliance can be placed on the system to help management achieve its objectives;
- Providing management of each organisation with assurances that systems are doing what they were designed to do;
- Making constructive and practical recommendations to strengthen systems and manage identified risks; and
- Using the findings of the audits of individual systems to feed into an overall assurance on the adequacy of controls.

The audit of a system will normally involve the following stages:

- Ascertaining and recording the system by:
  - Identifying the objectives of the system;
  - Identifying all activities involved, covering inputs, processes and outputs;
  - Establishing control objectives;
  - Identifying risks; and
  - Identifying controls.
- Evaluating controls against risks;
- Testing the operation of the controls to establish whether they can be relied upon;
- Arriving at conclusions – by assessing what has been discovered during evaluation and testing to form an opinion on the reliability and adequacy of internal control.

## **Compliance Audit**

An alternative approach to Systems Based Audit is Compliance Audit. It is frequently adopted by external audit and is available to the internal auditor where he/she feels it is appropriate.

The main objective of Compliance Audit is to confirm the accuracy and correctness of the records and assets of the organisation and to ensure compliance with all relevant statutes and regulations. It usually involves large sample sizes in order to comply with the auditors' standard on appropriateness of evidence and may incur a large commitment of auditor time.

A compliance audit will normally involve the following stages:

- Identifying all accounting records;
- Selecting audit objectives;
- Designing tests to substantiate records; and
- Arriving at conclusions and an opinion.

Some examples of where compliance audit can be used are where:

- There are limitations on the internal control procedures which have been designed into the system;
- The auditor assesses a very high control risk and therefore reliance cannot be placed on just carrying out limited tests of the controls in the system; and
- It is considered to be more cost effective, for example in the case of small systems where it may not be appropriate to spend lots of time documenting systems.

## **Performance Audit**

Performance audit – also referred to as Value for Money Audits (VFM), Management Audit or Operational Audit – is the assessment of whether public resources are used in a way which achieves the organisation's objectives in an economical, efficient and effective manner.

It is an objective and systematic examination of evidence in order to provide an independent assessment of the performance of a government organisation, program, activity, or other function. It is intended to provide information to improve public accountability and facilitate decision-making by those responsible for overseeing or initiating corrective action.

Performance audits can be very complex and should not be done by inexperienced audit staff. It is unlikely that any will be done in the first two years of setting up an IA unit.

The benefits of performance audits include:

- Improving specification of the goals of policies and the ways of achieving particular policies;
- Improvement of the impact of programs and policies;
- Increasing outputs;
- Minimisation of costs and growth of revenues or benefits;
- Improvement of management performance, the level of internal control and the level of accountability;
- Provision of an independent overview of the area/results/impact;
- Development of assessment criteria for use in planning and managing future programs and activities;
- Drawing the attention of management to a problematic area; and

- The ability to identify best practice in one part of an organisation and adopt it in other relevant areas.

Therefore, performance audit frequently puts emphasis upon auditing control and information systems that support the production of data relating to the objectives, impacts and resources of a specific policy.

Performance audits –are concerned with the soundness of management policies and practices with respect to the Economy, Efficiency, and Effectiveness of the operations.

*Economy* is obtaining supplies and services of an appropriate quality at the best possible price.

*Efficiency* is using those supplies and services in the most effective way to achieve the required result or output.

*Effectiveness* is an assessment of the extent to which the actual outputs of each system or program meet the desired objectives and achieve the intended impact.

Performance audit differs in emphasis from systems audit. Systems audit involves an assessment of the systems of control established by management, but tend to focus more upon the adequacy of those controls. Unlike performance audits they do not normally attempt to evaluate the results and outputs of the system under review.

Some typical controls with which performance audits are concerned are:

- Planning (including setting objectives);
- Management information;
- Performance measures and indicators;
- Policy performance; and
- Evaluation and suitable control over costs.

In certain circumstances, specific performance audits may be conducted at the request of management, or if a systems audit indicates that a more detailed performance review is required to evaluate the outputs of a specific system. Such audits could involve investigating signs of possible waste; the effect of important projects or the efficient conduct of standard managerial operations.

Performance audits typically involve:

- Establishing clearly the area for review;
- Using all available sources, both internal and external;
- Establishing the true scale and scope of the function or activity to be reviewed;
- Comparing levels of spending and activity over time and against available comparable organisations within the public sector, and where relevant outside it (benchmarking); and
- Being prepared to question what is being done and why? And being willing to identify and consider alternative approaches; and

Recommending alternative approaches and establishing the costs and benefits associated with them. The term Performance Audit also includes **Program Audits** which focus on determining:

- The extent to which the desired results or benefits established by the organisation are being achieved;
- The effectiveness of the organisation's programs, activities, or functions; and
- Whether the organisation has complied with significant laws and regulations applicable to the program.

Program audits may, for example

- Assess whether the objectives of a new, or ongoing program are proper, suitable, or relevant;
- Determine the extent to which a program achieves a desired level of program results;
- Assess the effectiveness of the program and/or of individual program components;
- Identify factors inhibiting satisfactory performance;
- Determine whether management has considered alternatives for carrying out the program that might yield desired results more effectively or at a lower cost;
- Determine whether the program complements, duplicates, overlaps, or conflicts with other related programs;
- Identify ways of making programs work better;
- Assess compliance with laws and regulations applicable to the program;
- Assess the adequacy of the management control system for measuring, reporting, and monitoring a program's effectiveness; and
- Determine whether management has reported measures of program effectiveness that are valid and reliable.

An example of a program audit would be a review of the system for administering and distributing aid to local communities following natural disasters such as flooding.

### **Financial Audit**

In internal audit financial audit is normally limited to evaluating the financial systems of an organisation. The internal auditors' primary interest is not the accounting reports and figures as such, but rather the controls which ensure the quality and accuracy of accounting information and of financial reporting.

Financial audits include:

- *The audit of financial and accounting statements and reports* which are intended to provide reasonable assurance about whether the financial statements of an organisation present fairly the financial position, results of operations, and cash flows and that they have been prepared in accordance with generally accepted accounting principles; and
- *Financial related* audits which include determining whether: (i) financial information is presented in accordance with established or stated criteria, (ii) the organisation has adhered to specific financial compliance requirements, or (iii) the internal control structure relating to financial reporting and/or safeguarding assets is suitably designed and has been implemented in an appropriate and effective way.

Financial related audits may, for example, include audits of the following items:

- Segments of financial statements; financial information (for example, statement of revenue and expenses, statement of cash receipts and disbursements, statement of fixed assets); budget requests; and variances between estimated and actual financial performance;
- Internal controls over compliance with laws and regulations, such as those governing bidding for, accounting for, and reporting on grants;
- Internal controls over financial reporting and/or safeguarding assets, including controls using computer-based systems;
- Compliance with laws and regulations; and
- Allegations of fraud.



## Information Technology Audit

Information Technology (IT) Audit is the application of auditing skills to the technological aspects of business processes. It embraces the independent review and testing of practices and procedures related to:

- The secure provision of business processing;
- The processes for planning and organising IT, and developing and acquiring new systems and facilities; and
- The economy, efficiency, and effectiveness of the use and exploitation of Information Technology facilities.

All auditors are expected to be familiar with the basic concepts of internal control as applied to Information and Communication Technology (ICT) business systems and processes within the organisation. The audit of controls in such systems will normally form part of the standard systems audit. However, the increasing complexity and diversity in the application of technology means that more specialised IT skills will be needed for the review of specific activities.

IT Auditors provide advice and support to other auditors in respect of:

- *IT strategies, planning, organisation and policies.* This involves:
  - Helping to provide an overview of IT systems and identify areas of greatest risk;
  - Testing the effectiveness of the segregation of duties and authority within the IT domain; and
  - Examining the procedures relating to ICT developments (projects, quality assurance etc).
- *Systems development controls*  
Internal Audit should be able to advise on controls at the earliest possible stage in the systems development process. In this way controls can be installed more easily and at lower cost.

Ideally IT auditors should have the opportunity to input – through their comments on documents submitted to them or by discussing the proposed process – at each stage of the development process, including:

- Determining the need for the system development;
  - Establishing the objectives for the new system;
  - Consideration of alternative approaches to the development;
  - Organising and controlling the development process;
  - The systems implementation phase; and
  - Post-implementation evaluation.
- *Applications (or business systems) controls*  
In order to examine, test and evaluate computerised controls in live systems, and the technical documentation supporting computerised elements of systems, it is necessary to carry out application control audits. These audits involve:
    - Operations Testing – which means examining whether the application provides expected outputs in relation to standard inputs. Standard test files may be used to test the operation of all parts of the system after each change in the system is implemented. Regular automated testing can speed up the implementation of new versions.
    - Security Tests – involve examining the actual access rights and how these are built into the working of the application (data reading and writing, user administration, administrator rights to new installations etc). Security testing also deals with the

existing application outputs while examining whether sensitive data are not passed on to less secure systems.

The audit planning process should take account of the need for an integrated approach which addresses both computer and user controls, and the potential for using computer assisted audit techniques to enable testing of large quantities of data.

- *ICT Environmental controls*

This involves assessing the extent to which controls over resource management, technical support, business continuity/disaster recovery and security are adequate and effective

- *Infrastructure controls*

This focuses on the security, integrity and availability of the infrastructure, including the network, servers and internet access. Auditors may focus, for example, on the configuration changes in individual ICT items, and on whether the changes have a significant impact on the security or operation of the entire system.

- *Locally-developed systems controls*

Systems developed by individual departments and sections may pose risks to the organisation, e.g. they may give rise to poor security or involve improper use of software. These systems are often not subject to independent testing and as such they are more susceptible to operation errors.

- *Contracted services controls*

Contracted services must be monitored and assessed for performance. Valid contracts must include a provision stipulating the quality of service required. Procurement relating to particularly complex systems and services can be a high risk area, since often there is a great dependency on a single supplier.

## Glossary of Terms

This glossary gives a brief description of significant terms used by internal auditors.

### **Assurance**

The Head of Internal Audit's professional opinion on the adequacy, effectiveness, and reliability of the department's internal control system.

### **Audit cycle**

The length of time over which all systems in the agreed audit needs assessment will be audited.

### **Audit evidence**

The information obtained by internal auditors to arrive at and to support their findings and recommendations.

### **Audit needs assessment**

An assessment of the systems covering the whole range of the organisation's activities, their relative importance; the frequency with which each should be audited and the resources required to do so.

### **Audit work plan**

A detailed plan that sets out the direction and control of an individual audit assignment.

### **Benchmarking**

Is a process whereby one organisation is able to compare its performance with that of one or more other organisations, in order to establish comparative measures of performance.

### **Compliance testing**

Testing designed to establish whether the controls established by management are operating as intended and are effective.

### **Control environment**

Sets the tone of an organization. Control environment factors include the integrity, ethical values, management's operating style, delegation of authority systems, as well as the processes for managing and developing people in the organization.

### **Control objectives**

The objectives of control, derived from the management objectives of the system, used by the auditor as criteria against which to appraise the adequacy of internal controls.

### **Controls**

Individual actions, procedures or operations taken or put in place by management in order to ensure that activities and procedures achieve their objectives.

### **Current audit file**

A file of audit documents put together during the course of a specific audit.

### **Detective control**

A control designed to detect error, irregularity, inefficiency, or other failure to meet management's objectives.

**Directive control**

A control designed to detect and correct inefficiencies, errors, or irregularities. They normally operate after an event has occurred or an output has been produced.

**Due professional care**

The standard of competence and diligence internal auditors should exercise in carrying out their duties.

**Economy**

Is obtaining supplies and services of an appropriate quality at the best possible price.

**Efficiency**

Is the use of supplies and services in the most effective way in order to achieve the required result or output.

**Effectiveness**

Is an assessment of the extent to which the actual outputs of the organisation/activity meet the desired objectives and achieve the intended impact.

**Exposure**

The product of risk and materiality, where these can be quantified.

**External auditor**

An auditor whose main function is to give an opinion on financial statements in related to a specified time period.

**Flowcharting**

A diagrammatic method of recording and describing a system which can show the flow of documents, information or processes and the related controls within that system.

**Framework of control**

A description of the range of controls present within an organisation, usually including classification of controls and other control measures.

**Frequency of audits**

The number of times an audit should be undertaken within the audit period.

**Interim review**

A limited audit examination of a system previously subject to a full systems audit.

**Internal audit**

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

**Internal control**

A process carried out by management and other personnel designed to ensure that objectives are achieved. Further guidance on Internal Control is given in Appendix C.

**Internal control questionnaire**

A list of questions, related to control objectives, used by internal auditors to assist in the evaluation of internal control.

**Internal control system**

The whole network of systems established in an organisation to ensure that its objectives are achieved and in the most economic and efficient manner.

**Judgement sampling**

Selection, based on the auditor's experience, knowledge and understanding of the system, of a sample of items for audit testing that are representative or that will yield relevant audit evidence.

**Materiality**

The significance of undesirable events which are identified or which may occur. Applied to systems it reflects the significance of a failure to achieve management's objectives.

**Objectives**

Statements of what is planned to be achieved.

**Output measure**

A directly quantifiable means of assessing what is produced or achieved.

**Performance indicator**

This is an indirect measure of the extent to which effectiveness, efficiency and economy, quality and service levels have been achieved in an activity or function. Normally used where direct measures are not available.

**Performance measure**

This is a directly quantifiable means of assessing the extent to which effectiveness, efficiency and economy, quality and service levels have been achieved.

**Performance audit approach**

The assessment of whether public resources are used for fulfilment of the objectives of the organisation in an economical, efficient and effective manner. It encompasses the audit of the economy, efficiency and effectiveness of a system, service or activity (also known as value for money auditing), and program audit.

**Permanent audit file**

A file of audit documents, relating to the audit of a particular system or group of related systems, that provide ongoing and live information that is likely to be of continuing relevance to future audits.

**Preventive control**

A control designed to prevent error, irregularity or inefficiency.

**Priority of audits**

The extent to which an audit assignment needs to be undertaken earlier rather than later in the audit programme.

**Quality assurance**

A combination of internal and external reviews to provide reasonable evidence that audit work conforms to the standards and best practices defined in Internal Audit Methodology.

**Re-performance test**

An audit test which functions by re-processing a transaction or re-performing a procedure to compare the auditor's result with that already achieved.

**Risk**

The likelihood of undesirable events occurring. Risk in systems may be viewed as the chance (or probability) of one or more of management's objectives not being met.

**Risk analysis**

A formal method of evaluating the vulnerability of a particular system or group of systems.

**Risk elements**

The factors to be quantified in determining risk and materiality in audit planning.

**Risk index**

A method of combining risk elements in determining the relative risks and materiality associated with systems in audit planning.

**Scope of an audit**

The extent/coverage and range of an audit.

**Short-term (or Annual) plan**

A detailed statement of the audit plans for the year ahead derived from the strategic plan.

**Statistical sampling**

Methods of sampling whole populations so that conclusions may be drawn about all the items which make up those, to particular levels of confidence (certainty).

**Strategic plan**

A statement showing how the audits identified in the agreed audit needs assessment will be covered over the audit cycle – typically three to five years.

**Compliance testing**

Testing of transactions and other data to enable a conclusion to be reached on the completeness, accuracy and validity of data tested and on the effect of weaknesses in internal control.

**System**

A series of related activities designed to operate together to achieve a planned objective.

**Systems based audit approach**

The structured analysis and evaluation of the internal controls of a system, process or area of activity in relation to appropriate control objectives.

**Systems weakness**

A breakdown in or lack of suitable or sufficient control(s) to ensure that the system objectives will be achieved.

**Value for money**

An audit whose objectives focus on one or more aspects of the economy, efficiency or effectiveness with which resources have been used.

**Verification**

Checking the accuracy, completeness and validity of information and records by comparing the stated position with actual conditions or with independent records to establish consistency.

**Vouching**

Checking a transaction with supporting documentation.

**Walk through testing**

A preliminary examination of a system to confirm the auditor's understanding of the way it functions; sometimes called 'cradle to grave testing'.

## WHAT IS INTERNAL CONTROL?

### Definitions

The most widely accepted definition of 'internal control' is that developed by COSO (Committee of Sponsoring Organisations of the Treadway Commission). This states that:

"Internal control is broadly defined as a process effected by management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following overlapping categories:

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

The COSO control framework identifies five interrelated control categories that together provide effective internal control:

- **Control Environment** - The core of any organisation is its people. Their individual attributes of integrity, ethics and competence and the environment in which they operate determine the success of the operation.
- **Risk Assessment** - Organisations must be aware of, and deal with, the risks that they face. They must set objectives that integrate key activities. They must also establish mechanisms to identify, analyze and manage the related risks.
- **Control Activities** - Control policies and procedures must be established and executed to help ensure that actions necessary to achieve the university objectives are effectively carried out.
- **Information and Communication** - Surrounding the control activities are information and communication systems. These enable the organisation's people to capture and exchange the information needed to conduct, manage and control its operations.
- **Monitoring** - The entire process must be monitored and modified as necessary. Thus, the system can react dynamically to changing conditions.

Within the EU DGBUDG has provided a definition of internal control in the public sector – usually referred to as Public Internal Financial Control (PIFC) – as follows:

"The overall financial control system performed internally by a Government or by its delegated organisations, aiming to ensure that the financial management and control of its national budget spending centres (including foreign funds) complies with the relevant legislation, budget descriptions, and the principles of sound financial management, transparency, efficiency, effectiveness and economy. PIFC comprises all measures to control all government income, expenditure, assets and liabilities. It represents the wide sense of internal control. It includes but is not limited to ex ante financial control (EAFC) and ex-post internal audit (EPIA)".

## **Internal auditors and internal control**

When auditors are considering the adequacy of the systems of internal control there are a number of things they have to keep in mind.

First, it is important to remember that an effective system of internal control should have the following characteristics:

- Establishment of standards;
- Measurement of actual performance;
- Analysis and comparison of actual results to standards;
- Implementation of a program of corrective actions; and
- Review and revision of the standards.

Second, controls should be economical in time and money and should measure performance in relation to the planned result. Controls should also be timely and easily understood by the people using them. Good controls will reflect the goals of the audited organisation, indicate when the goals are not being achieved and measure the critical items - those that have the most impact on achieving goals.

Third, the risk of failure and the potential effect of not achieving objectives must be considered, along with the cost of establishing the control. Excessive control is costly and counterproductive. Too little control presents undue risk and there should be a conscious effort made to strike an appropriate balance.

Finally, internal audit is concerned not only with internal control in the critical financial systems, but also the entire range of managerial and operational systems in the organisation being audited.



# **INTERNAL AUDIT MANUAL**

## **PART TWO: PERFORMING AN AUDIT**

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## **2 1. INTRODUCTION**

This Part of the Audit Manual provides guidance on how to carry out an audit. It sets out the methodology to be used by internal audit in the public sector in Montenegro. The methodology relates primarily to systems audits (which will form the basis of the majority of the work done by internal audit. However, the same basic approach and principles apply to other types of audit, for example performance audits and information technology audits.

All audit staff are expected to make themselves fully aware of the contents of this Part of the Audit Manual, and to use these procedures in their audit work. In some cases it may be necessary to adapt the procedures to reflect the situation in a particular organisation and those changes should be approved by the Head of Internal Audit in consultation with CHU.

When carrying out audits every auditor needs to keep in mind the need to comply with the Professional Standards set out in Part 1 of the Audit Manual. To help you in your day-to-day work the relevant Standard is shown at the start of each of the main stages of the audit process.

In general, good systems audits depend upon:

- (a) Careful planning of each audit, in order to determine where the work should be done and to allocate resources, effectively. Planning also helps to ensure that the concepts of risk and significance together are properly considered and that audits are tailored to the circumstances of the audited body
- (b) recognising that each part of an individual audit needs to be viewed in the context of the full audit plan, i.e., that no single audit stands alone
- (c) adopting a constructive and positive approach to the way the audit is done
- (d) reporting to management, in a timely and appropriate way, highlighting matters of significance arising from audit work and making suitable recommendations for corrective action
- (e) establishing arrangements to ensure that the audited organisation has properly considered any matters identified during the audit and implemented agreed actions.

Section 2 of this Part of the Manual sets out the main stages of an audit, and provides guidance on how to approach each of them. The remaining sections deal with some other key areas that impact on the effectiveness of internal audit – follow-up audits, the structure of audit files and the supervision of individual audits (to be developed later).

## 2. THE MAIN STAGES OF AN AUDIT

These are as follows:

2.1 Planning the Audit	<ul style="list-style-type: none"><li>•Preliminary Review</li><li>•Terms of Reference</li><li>•Preparing the Audit Plan</li><li>•Audit Start-up Meeting</li></ul>
2.2 Recording the System	<ul style="list-style-type: none"><li>•Identify/confirm System Objectives</li><li>•Define the Control Objectives</li><li>•Establish &amp; Record the System</li><li>• Check the System is Recorded Correctly</li></ul>
2.3 Evaluating the System	<ul style="list-style-type: none"><li>•Identify and Record the Risks and Actual Controls</li><li>•Evaluate the Actual Controls in the System</li></ul>
2.4 Testing	<ul style="list-style-type: none"><li>•Test the Actual Controls</li></ul>
2.5 Audit Conclusions	<ul style="list-style-type: none"><li>•Complete the Audit Findings Schedule</li></ul>
2.6 Audit Reports	<ul style="list-style-type: none"><li>•Draft the audit report</li></ul>
2.7 Action Plans	<ul style="list-style-type: none"><li>•Obtain agreed action plan</li><li>•Verify action is taken by management</li></ul>

## 2.1.1 2.1 PLANNING THE AUDIT

### **2200 Engagement Planning**

Internal auditors must develop and document a plan for each audit, including the audit's objectives, scope, timing and resource allocations.

Planning is a critical stage for any audit. It ensures that managers are actively involved in the audit right from the beginning and that the audit focuses on the right things. There are four main steps to the planning process and these are set out in detail below.

#### **2.1.1.1 Step 1 - Preliminary review**

Approximately six to eight weeks before the audit is scheduled formal notification should be sent to the department/unit concerned informing them that an audit will be taking place and that Internal Audit staff will be carrying out some preliminary work before holding the formal set-up meeting.

The notification should take the form of a brief letter informing the manager responsible for the area to be audited of:

- The name of the audit – with reference to the annual audit plan
- The fact that it will be necessary to carry out some preliminary work (involving meetings with managers and, possibly, some staff) to establish the precise scope and focus of the audit
- The fact that a formal meeting to set up the audit will take place before the audit begins.

This fact-finding exercise (known as a preliminary review) is designed to provide an overview of the area to be audited. It also acts as the basis for planning the audit, and for determining:

- The objectives of the audit;
- The extent of audit coverage and identification of any specific areas that are to be given emphasis because they are high risk, are of critical importance to the system and/or suffer from weaknesses which are already known (e.g. the system depends upon computer systems which are outdated) ;
- Target dates for completion of each stage of the audit work; and
- Which auditors are to be employed on the audit and who is to be responsible for supervising the audit and ensuring the quality of the audit work.

The preliminary review should clearly define the audit of the system as set out in the annual work plan; establish the boundaries of that system (where they start and where they finish) and identify any interfaces with other systems and any other related audits that are planned in the future. This provides the basis for drafting the Terms of Reference for the audit, including the objectives, scope and coverage of the audit, which should then be agreed with management responsible for the area under review.

The preliminary review could involve:

- A review of the business and operational plans of the area to be audited (where available);
- A review of current organisation charts;

- A n assessment of budget and management information (where available) ;
- Initial discussions with management to establish to establish their objectives for the area to be audited, and
- A review of relevant legislation, regulations, instructions etc

The review of previous audit reports (where work has been carried out in the past) is an important part of the preliminary review. Such reports can provide an insight into the level of control at the time of the last audit, and an opportunity to establish whether or not agreed recommendations relating to previous audits have been implemented by management. It is also useful to review any relevant reports produced by the Supreme Audit Institution (SAI).

At meetings with heads of departments and units during this stage of the audit you should try to:

- identify and discuss the objectives the system is designed to achieve;
- discuss the relevant business activities and gain an understanding of any significant risks that may impact upon them;
- obtain an overview of the roles, responsibilities and reporting lines of the staff involved ;
- discuss any concerns or particular areas the manager concerned would like audit to review, and
- discuss the possible scope of the audit.

At the end of the preliminary review it is often useful to hold a meeting with the management of the department or unit concerned to discuss the initial findings

#### **2.1.1.2 Step 2 - Terms of Reference**

##### **2210 Engagement Objectives**

Objectives must be established for each engagement.

##### **2220 Engagement Scope**

The established scope must be sufficient to satisfy the objectives of the engagement.

##### **2230 Engagement Resource Allocation**

Internal auditors must determine appropriate and sufficient resources to achieve engagement objectives based on an evaluation of the nature and complexity of each engagement, time constraints and available resources.

Having done all this, the Terms of Reference for the audit should be prepared. These set out the scope, approach, and timescales for the project. The template below shows the information which should be included in the Terms of Reference.

## Template for Terms of Reference

Working Paper Ref .....

Prepared by: .....

Reviewed by: .....

<b>Audit Plan Ref:</b> Audit 4/2011 – Low Value Public Procurement
<b>Key Business/System Objectives:</b>  To procure low value goods and services at the lowest cost To use local providers of goods and services as much as possible
<b>Audit Objectives:</b>  To review the adequacy and effectiveness of the controls over the procurement of low value goods and services To establish whether the procurement of low value goods and services is in accordance with public procurement guidelines
<b>Scope of Audit:</b>  The audit will cover the systems for preparing and approving requisitions; the procedures for placing orders and the procedures for ensuring the receipt of goods and services.
<b>Key Contacts:</b>  Names
<b>Previous Audit Findings:</b>  None – this is the first audit of this system
<b>Points to note:</b>  The head of the procurement department was only appointed three months ago and has no prior experience of recruitment.
<b>Timing of audit:</b> The audit is schedule to start on 11 July 2011 and fieldwork will be completed by 29 July. A draft report will be available by 12 August
<b>Auditor(s):</b>  Names

The audit objectives are an important part of the Terms of Reference. They must be clear and concise and relate to the key areas of concern to be addressed by the audit. An example of possible audit objectives is shown below.

**Possible objectives for a payroll audit**

To conduct an audit of the payroll systems in the Ministry of Culture to ensure that they comply with all relevant legislation, laws, management policies and procedures.

To establish that the payroll systems operate so that staff are paid correctly and on time.

To establish that the payroll procedures are efficient and effective.



### 2.1.1.3 Step 3 - Audit Plan

the development of an audit plan. Below is a template for an audit plan. The plan should indicate the expected audit days to be spent on each stage of the audit. It should also include time for review and supervision by the Head of Internal Audit.

## INTERNAL AUDIT PLAN

AUDIT NAME: Payroll

AUDIT NUMBER: 01/2011

AUDIT DURATION 4 - 22 July

Stage	Date from / to	Auditor name/ days	Auditor name/ days	Auditor name/ days	Total for the stage
		Petrovic	Markovic		
Planning the audit		3			3.0
Recording the system		2			2.0
Evaluating the system – including testing		4			4.0
Audit conclusions		1			1.0
Audit report		3			3.0
Management/supervision			1		1.0
TOTAL		13.0	1.0	0.0	14.0

Once completed the audit plan should be approved by the Head of Internal Audit.

#### **2.1.1.4 Step 4 - The audit start-up meeting**

This is the final step of the planning stage, and comprises the following activities.

##### *Notification of the audit*

Before the audit start-up meeting formal notification of the audit should be prepared and sent to the Head of the department/unit responsible for the system that is to be audited. This letter should cover the following:

- The subject of the audit – with reference to the annual audit plan where appropriate or, for a consulting audit, indicating that the audit is a management request
- The objectives and scope of the audit
- The start date of the audit
- Who will be doing the audit.

The notification of the audit should also propose a meeting (the audit start-up meeting) to discuss the audit and finalise the necessary arrangements.

An example of a letter of notification is given below.

## Notification of the Audit



**Montenegro  
Government of the Montenegro  
Ministry of Internal Affairs**

Number:

Podgorica, \_\_\_\_\_

**Attn: Deputy Minister/Head of Unit  
Mr (Mrs) .....**

**INTERNAL**

**Subject: Review of the Budget Planning Processes**

In accordance with the annual audit plan agreed for 2011 the Internal Audit Unit will perform an audit of Low Value Public Procurement by the Ministry. The coverage and objectives of this audit will be as follows:

### **1. Coverage**

The audit will cover the systems for preparing and approving requisitions; the procedures for placing orders and the procedures for ensuring that the required goods and services are received.

### **2. Objectives of the Audit**

The objectives of the audit will be:

- To review the adequacy and effectiveness of the controls over the procurement of low value goods and services
- To establish whether the procurement of low value goods and services is in accordance with public procurement guidelines

### **3. Date of commencing the audit**

The audit is planned to start on 11 July 2011.

### **4. Conducting Audit**

The audit will be carried out by \_\_\_\_\_ and \_\_\_\_\_. Upon completion of the fieldwork, we will prepare a draft audit report that will be sent to you for your consideration. After that, we will organise the exit interview in order to discuss our recommendations and to consider any comments you may have. Following that a final report will be issued.

### **5. Opening Interview**

We will be in touch with you shortly to discuss the proposed coverage and objectives of the audit. If there are any specific concerns you have about the systems for Low Value Procurement we will be very happy to discuss these with you at this meeting.

**Head of Internal Audit,  
(name)**

**Delivered to: (name), Head of procurement  
[Copy to: Minister of Internal Affairs]**

### *Start-up meeting*

This meeting should be held with the Head of the department or unit to be audited. The Head of Internal audit should be involved, together with the auditor carrying out the work.

The meeting is intended to:

- Introduce the auditor to the management of the department or unit;
- Outline the purpose of the audit and give a brief overview of the methodology to be used – if this is the first time an audit has been done in the department or unit it will be necessary to give a more detailed explanation of the way the audit will be carried out;
- Provide an opportunity for management to suggest particular areas which they think should be examined;
- Discuss Internal Audit's proposals on the possible focus of the audit ; and
- Explain that they will be kept informed of the progress of the audit, and that management's assistance will be welcomed throughout the audit.

Some guidance on how to approach the opening meeting with management is given in Appendix A.

Following the meeting Minutes should be prepared and retained on the audit file. Those minutes should be kept brief – possibly in the form of bullet-points.

## 2.1.2 2.2 RECORDING THE SYSTEM

### **2300 Performing the Engagement**

Internal auditors must identify, analyse, evaluate and document sufficient information to achieve the engagement's objectives.

This part of the audit requires the auditor to obtain a clear understanding of the relevant system. This is achieved by interviewing the managers and staff who operate, and are responsible for, the system being audited and by reviewing relevant written procedures and other documentation relating to the way the system operates.

Interviews form a key part of the audit process and it is important that they are handled in an effective way. Guidance on arranging and handling meetings is provided in Appendix A.

#### **2.1.2.1 Step 1 - Identify & confirm the system objectives**

However, before starting to record the system it is necessary to find out the objectives that management has for the system (the system objectives).

When you are trying to find out what the system objectives are you should remember that in every system there will be a hierarchy of objectives - starting with those objectives set by senior management and working down to the objectives of the people involved in the detailed operation of the system.

For example in a procurement system the objectives set by senior management might include:

- To ensure that Montenegrin law and legislation and EU requirements are met when placing procurement contracts;
- To reduce the cost of procurement by 5% each year for the next three years;
- To make the existing system for approving expenditure more efficient, and
- To reduce the backlog of invoices awaiting payment.

System objectives such as these are often set out in a formal way – for example as part of the strategic plan for the organisation – but sometimes there may be other informal, undocumented system objectives and the auditor needs to be alert to the possible existence of these.

Operational objectives will often be broader and more generic at the management level, and become more specific for staff at lower levels in the organisation. For example, the Head of the Procurement function may have an objective that is:

- 'to ensure all procurement is carried out in accordance with the Public Procurement Rules'.

The procurement staff, however, may have more specific objectives that relate to their specific role, for example:

- 'to ensure that three tenders/quotations are obtained' or
- 'to ensure that tenders received are not opened before the due date'.

### 2.1.2.2 Step 2 - Define the control objectives

Control objectives are a key part of the audit process. They provide the primary focus for the evaluation of the system of control. By obtaining an understanding of what the objectives of the system are, it will help you to identify what the control objectives of the audit should be. The control objectives you set need to be consistent with the objectives of management in the organization, and should be discussed and agreed with management – ideally before you start any evaluation of the controls in place.

Control objectives provide the framework for each systems audit assignment. They should detail the various aspects of a system's objectives, and provide the basis for evaluating the actual controls in the system. Control objectives should be specific enough to provide the basis for this evaluation. Control objectives that are generalisations such as "to ensure that support services are adequate" should be avoided.

Considering the relevant laws can be a useful starting point for identifying control objectives, but the nature and types of risk that could impact upon the system together with the control environment must also be considered.

One useful way of developing control objectives is to think about the organizational structure relating to the area you are auditing. This involves:

- Identifying the main sections/units affected by the audit;
- Establish the main activities carried out by each of those main sections/units;
- Determining the management objectives of each of those activities, and
- Developing the control objectives which will help ensure the achievement of the management objectives for each of the main activities.

As a simple guide it may be useful to work on the basis of one control objective for each activity – although this rule should not be applied too rigidly. It is recommended that there should be no more than 6 to 8 control objectives for any audit.

For example with procurement the main sections/units involved could be: the department(s) requesting the supplies, services or works; the purchasing/contracts section; the department(s) receiving the goods or services and the accounts department.

For each of those sections or units you can then establish the activities which they carry out and this will help you to decide on the control objectives. So, for procurement:

- The *department requesting the supplies, services or works* will be concerned with preparing the commitment request/purchase requisition and (in many cases) receiving the supplies, services or works. A possible control objective could be:
  - 'to ensure that all purchase commitments are prepared correctly and at the right time';
- *Purchasing/contracts section* will be involved in: processing purchase requisitions; ordering; tendering and contracting; maintaining the supplier database etc. A possible control objective could be:
  - 'to ensure that all purchases are made on the basis of suitably authorized commitment requests and in accordance with laid down procedures';
- *Accounts department* will be receiving invoices; validating and paying invoices; maintaining supplier payment files etc. A possible control objective could be:
  - 'to ensure that invoices are only paid for goods or services which have actually been received, and in accordance with the terms set out in the purchase order'.

Another approach to developing comprehensive control objectives is to consider aspects of control such as:

- Has the system been adequately planned?
- Are the operations adequately supervised and controlled?
- Is the system periodically reviewed?
- Is suitable management information produced?

Control objectives should relate to the specific features of the system and the way in which the activities are carried out in order to achieve the system objectives. They should also be specific and show the purpose of control - and not the control itself. For example:

- In a purchasing audit one control objective might be 'to ensure that invoices are paid only for goods or services which have been received';
- In a payroll audit a control objective could be: 'to ensure that payments are made only to valid employees of the organization'; and
- In a security audit a control objective could be 'to make sure that only accredited staff and visitors are permitted to enter the building'.

Wherever possible the system objectives and the control objectives relating to the system should be identified before work starts on recording the system and they can then be reviewed and revised, as necessary, once the system has been recorded and you have a full understanding of how the system works.

Further examples of control objectives for some of the common systems will be provided later.

Once the control objectives have been identified it is advisable to try to ensure that the manager who is responsible for the system to be audited agrees with objectives assigned to the system and the control objectives, which have been developed by internal audit.

### **2.1.2.3 Step 3 - Establish and record the system**

*Why do we need to do this?*

The main reasons for describing the system are:

- To confirm the auditor's understanding of the system;
- To establish any interfaces between systems;
- To establish how the system fits within the department or unit under review and the organisation as a whole; and
- To provide a basis for assessing the extent to which internal controls prevent or detect and correct errors.

The description of the system forms the basis for the auditor's judgements, conclusions, and recommendations. It also should provide a good basis for the evaluation of the strengths and weaknesses in internal control. Exclude any things which are not significant to the audit because recording the system can often take up a lot of time.

The auditor should decide which technique or combination of techniques for recording systems is most appropriate, taking into account the nature and complexity of the system, the audit objectives and any earlier audit work done.

### *Sources of information*

These can include:

- Files and papers from earlier audits;
- Organisational and procedural manuals used in the organisation;
- Interviews and informal discussions with managers and staff (detailed guidance on interview techniques is contained in Appendix A);
- Observation of the physical environment and the working methods used. It is particularly useful where there is no physical evidence remaining after the event that something has happened. Remember that the presence of the auditor may influence the behaviour of staff and the practices observed may not, therefore, be typical. It may also be difficult to substantiate the evidence;
- Documents and records used in the system;
- Reports prepared by the Internal Control Unit;
- Any other reports relating to the area under review; and
- Management information (e.g. budgets and other reports e.g. ones showing outputs, number of transactions processed, cash flows, revised plans).

### *Extent of the systems description*

This should be detailed enough to allow the user and the person reviewing the audit to understand how the system works and how internal control is achieved. Depending on the objectives of the audit, in some cases it may be necessary to record the complete system and in others it may only be necessary to record key areas of the system.

When recording the system it is important to:

- Record the system as it **actually** operates and not as the regulations or procedure manuals say it should operate;
- Identify and record all types of procedures and transactions covered by the system under review (including exceptions such as public holidays, staff holiday periods, unusual hours etc) ;
- Look carefully for controls - they may not always be clearly indicated or easy to identify;
- Record only the elements of the system essential to the audit evaluation;
- Copy only essential documents. Unnecessary copying of documentation can be wasteful and tends to make it difficult to review audit files, and
- Remember that the description of the system found in such documentation may be out of date and incomplete.

### *Steps to be taken when documenting systems*

Depending upon the nature and complexity of the system, the audit objectives and the results of the previous audit the auditor should carry out the following activities:

- Establish an outline/overview of the system to enable you to decide on whether to use narrative or flowcharts to document the system, and also to decide which of the main sub-systems it will be appropriate to describe separately;
- Obtain a detailed description of the systems and internal control features from discussions with departmental personnel. This should include:



- A record of which processes and procedures are carried out and by whom;
  - A record of any changes in or exceptions to the normal procedures for different types or groups of transactions (raising a commitment, an adjustment to salary payments, preparing contracts – eg those of high value;
  - A record of arrangements made to cover lunch hours, holidays or, for more significant transactions, peak flows of transactions;
  - Copies of all documents and forms used in the process; and
  - Copies of all computer reports which form part of the system, for example payroll listings showing names, salaries; lists of all requests for payment; fixed asset registers together with their purpose **and** the way they are used.
- Record information on flowcharts or notes. If possible compare them with internal procedure manuals;
  - Perform walk-through tests (see below) to ensure that the system actually does operate in the manner which has been described. (This should include both manual and computer systems;
  - Finalise the narrative or flowchart; and
  - Cross reference copies of documents and reports to the flowcharts. Blank copies of each of the main documents should be held in Section F - 'Sample Documentation' – of the Permanent Audit File.

When preparing this documentation, the auditor should remember that the amount of documentation should be limited to what is needed to identify and record the internal controls.

If they provide adequate explanation, copies of standard documentation and significant reports or summaries may form part of the audit record. System records should also show the sources of information e.g. manuals, interviews.

### *Systems documentation techniques*

The auditor should decide which technique of documenting systems is the most suitable for each audit: narrative descriptions, flowcharts or a combination of the two.

#### *(i) Narrative Descriptions*

A narrative description helps to give a complete and detailed picture of the system and should include:

- System objectives and targets;
- Links and interfaces with other systems;
- The environment in which the system operates;
- The allocation of authority and responsibility;
- All key controls and systems processes;
- Exceptional situations or cases that may need to be dealt with by the system e.g. certain very high level payments or commitments may have to be approved at the most senior level, whilst all others are approved at Head of Department or Head of Unit level; and
- Ad hoc controls such as management reviews.

Narratives may cover detailed descriptions of the movement of documents etc through the system, but in some cases these can be better recorded through flowcharts (see below).

To make them easier to understand it is often useful to divide narrative descriptions into:

- A simple overview of the system; and
- Separate detailed descriptions of the main constituent parts of the system.

Full use should be made of headings when preparing narrative descriptions to make it easy to identify the steps in the system and the key areas of activity. Narrative descriptions should also be set out and organised in a logical way in order to give a clear picture and make referencing and updating easier.

Wherever possible the source of the information and the names and titles of people interviewed should be recorded.

The narrative description should be recorded on the System Record document that is shown below.

<b>System Record Document</b>	
<b>Title of audit: 2/2011 = Staff recruitment</b>	
<b>Prepared by &amp; date:</b>	<b>Reviewed by &amp; date:</b>
<b>Activity No.</b>	<b>Description of activity</b>
<b>1</b>	Head of unit prepares request to recruit a new or a replacement member of staff. Forwards request to Deputy Minister
<b>2</b>	Request approved/rejected by Deputy Minister If rejected approval returned to Head of Unit Approved requests sent to Personnel Unit
<b>3</b>	Review of request by Personnel Unit. Check it is consistent with agreed systematisation.
<b>4</b>	Approval by Head of Personnel Unit.
<b>5</b>	Request sent to Minister for final approval
<b>6</b>	After approval by Minister the Selection Panel is set up. Minister approves membership of the Selection Panel. Details of the position and the type of person required are sent to the Panel.
<b>7</b>	Position is advertised in accordance with the regulations
<b>8</b>	Applications are received and processed by Personnel Unit. Checks are made to ensure that all documents requested are included with each application. Copies of the documents for each candidate are made and sent to each member of the Selection Panel.
<b>9</b>	Selection Panel reviews the applications and selects candidates for interview. A report is produced of the initial selection process.
<b>10</b>	Interview date and times set by Panel and Personnel Unit arrange interviews for candidates selected for interview. Invitation letters are sent to candidates.
<b>11</b>	Etc

*(ii) Flowcharts*

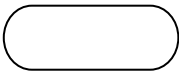


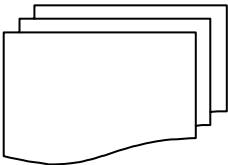
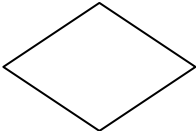
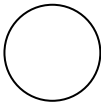
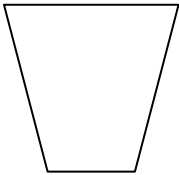
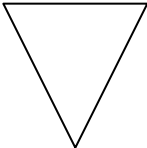
Flowcharting is a diagrammatic method of recording and describing a system which shows the flow of documents or information and the related internal controls within a system. Flowcharts can help:

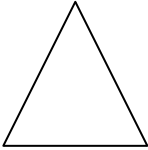
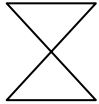
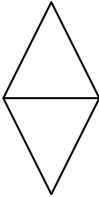
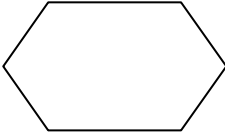
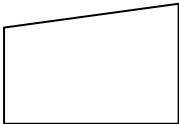
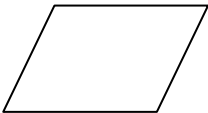
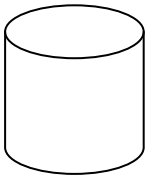
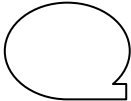
- To obtain a perspective on the whole system
- Gain an appreciation of the auditee's objectives
- Identify division of duties
- The person supervising the audit to identify areas which are not being covered by the review.

Flowcharts consist of symbols, each with a specified meaning, a brief explanatory text and connecting lines. The extent of any explanatory text depends primarily on the complexity of the processes and on who is going to use the flowchart.

Set out below are the standard symbols which should be adopted by Internal Audit. Microsoft Excel provides a basic flowcharting facility that will be adequate for the preparation of most flowcharts. There are also various audit flowcharting software packages that can be purchased.

## Common flowchart symbols

Symbol – manual/computer	Description
	Start or end point of flowchart
	Direction of flow of the activities in the process. Connects symbols on the flowchart.
	Process or operation. This can include a control eg signing a document, checking the contents of a document.
	Multiple documents – where there is more than one copy of a document prepared. The number of each copy in top right hand corner – 1, 2, 3 etc.
	Decision – yes or no; approve or reject; or alternative courses of action (if 'a' do this if 'b' do that)
	Connector – i.e. to another point in the flowchart on same page; to another point in the same flowchart on another page; or to a point in another flowchart. Identifying letter or number to be inserted in centre of symbol
	Manual operation – e.g. counting cash; preparing a hand-written receipt for money; checking existence of assets etc
	Extract data/information from a document or other source

Symbol – manual/computer	Description
	Merge one or more documents
	Collate a document or a number of documents
	Sort documents – for further processing, filing etc
	Preparation of a document, report, purchase requisition, invoice for charges
	Manual input to a computer based system – via keyboard or other process
	Computer input or output
	Magnetic disc storage/processing
	Computer tape storage/processing

It is sometimes useful to prepare an overview flowchart that shows the main steps of the system and the interrelationships between them. More detailed flowcharts can then be prepared for the various parts of the system. For example: in a procurement audit the overview flowchart might show the main steps in the procedure from the point at which goods or services are requested to the point at which the goods and services are received. More detailed flowcharts could then be prepared for each of the main stages such as requisitioning; tendering; evaluation and award of the contract; receipt of the goods or services etc.

Careful thought needs to be given to the number of levels required when flowcharting, and the auditor should limit the number of levels of a flowchart to whatever is necessary to depict clearly and precisely the system being audited, and to make it possible to identify the controls that exist in the system and possible areas of inadequate control.

There are two main types of flowchart:

1. **Horizontal flowcharts** (system flowcharts) describing the horizontal distribution of responsibilities (units, positions etc) by using columns; and
2. **Vertical flowcharts** depict the flow of transactions from first to last (beginning to end).

**When carrying out your audit you need to decide which is the most appropriate type of flowchart to use.**

Example of a horizontal flowchart:

Your flowchart should be divided into a number of columns as shown in the diagram below. The first column is for a brief description of each operation, while the other columns should be headed up with the title of a single individual or the names of a unit/department involved in the process - see the sample template below:. Microsoft Excel provides the facility to prepare flowcharts, and it is recommended that this is used for speed of preparation and ease of correction.

If you wish to prepare flowcharts manually you should use A3 landscape paper and try to restrict the number of columns to a maximum of five or six to make the flowchart less cramped and easier to use.

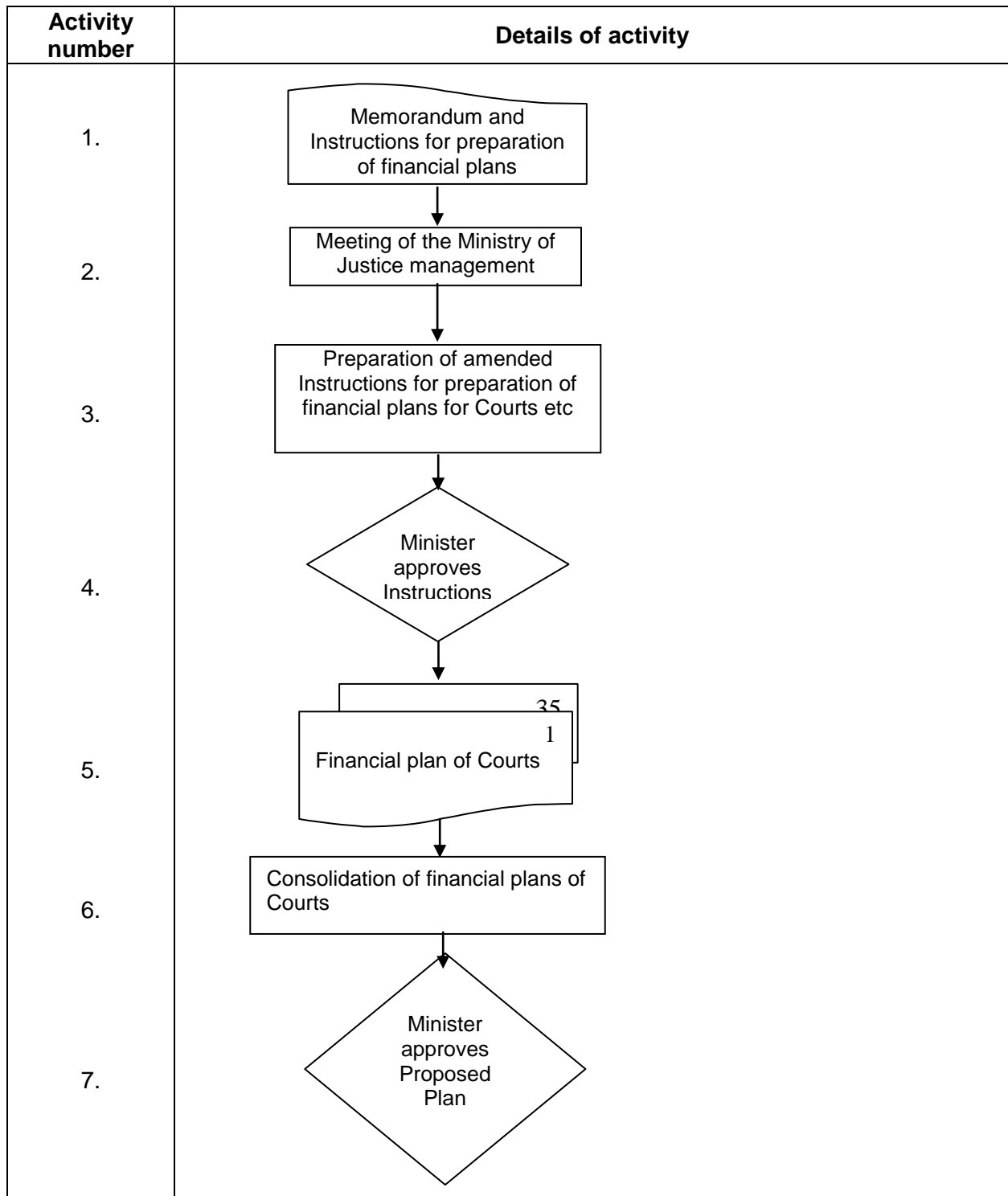
Working Paper Ref. No.....

**Example Format for Horizontal Flowcharts**

Purchasing system – audit (x) _____					Prepared by and date: _____	
Op No	Description of each operation	Unit requesting supplies or services	Purchasing unit	Unit receiving supplies or services	Invoice payment Unit	



### Example for Vertical Flowcharts



When preparing flowcharts remember:

- Flowcharts are primarily designed to show document flows rather than operations – although other operations can be explained by means of narrative notes if necessary;
- To avoid mixing up the 'regular' process and exceptional processes (two or three transactions per period) on the same flowchart. Prepare separate charts for the regular and the exceptional process or processes;
- To consider whether it is better to record the system by preparing one or more basic flowcharts which show the main flows in the system(s) - supplemented by narrative description where necessary;
- To flowchart the **actual** system. In a very few cases it may be necessary to record the 'official' system, and in those cases the charts must be labelled clearly to show whether it is the official or the actual system which is shown;
- The end product doesn't need to be a masterpiece – so don't waste time trying to make it perfect;
- That each flowchart should have a title, the date it was prepared and dates of any amendments to it and the name of the person who drafted it;
- To make sure that the processing of all documents (and of every copy of each document) is shown in full on the flowchart; and
- To think carefully before preparing a flowchart. Ask yourself whether it's really necessary or whether narrative description will be just as effective and less time-consuming.

### **Advantages and Disadvantages of Flowcharts**

Advantages of flowcharting are:

- Information can be easily communicated and assimilated;
- Flowcharts highlight the relationship between different parts of the system;
- The auditor can see the whole flow of documents: potential bottlenecks can be identified easily;
- Flowcharts offer a consistent method of recording;
- The auditor has to obtain a clear understanding of information flows in order to draw up a flowchart of a complex system; and
- Cross-referencing (e.g. being able to see any links and overlaps) between systems is made easier.

Disadvantages of flowcharts:

- The time they can take to prepare;
- They are limited in scope and may not identify managerial and organisational controls (eg the way in which activities are divided between different work units or responsibilities are divided) ;
- The techniques and conventions have to be learned and practised;
- Their creation may be more time consuming than a narrative description;
- They may become outdated quickly when a system is changing frequently – and they take a lot of resource to keep up to date. A narrative record may be more cost effective;
- Complex flowcharts may confuse rather than clarify; and
- Auditors usually need some training and experience before becoming proficient in preparing them.

It is often useful to use a combination of narratives and flowcharts – using flowcharts to describe more complex parts of the system. If flowcharts are used as well they and the narrative descriptions should be cross-referenced to each other.

## **Other points to consider**

### ***Organisation Charts***

The organisational structure relating to the system under review should be recorded. A copy of an existing organisation chart will suffice, as long as it is accurate and up to date.

An up-to-date chart will show details of the information chain, reporting relationships and responsibilities. It is also useful in identifying staff and deciding where audit testing needs to be done. The date the chart was prepared should be recorded.

The chart may include:

- Main sections/branches with a description of their functions;
- Job titles, grades and names of staff together with lines of responsibility; and
- Any other reporting lines – e.g. reports provided outside of the organisation, e.g. to the MoF.

### ***Minimum Contents of System Documentation***

Whichever method is used for documenting the procedures in each system there are certain items which should be included on every system file. These are:

- Examples of documents, with descriptions of their purpose and use. These documents and reports should be filed in the order in which they are used in the system, and cross-referenced to the narrative note or flowchart;
- Examples of reports, whether computerised or manually prepared, describing their purpose and use;
- Details of the number of transactions passing through the system (volume summaries). These are essential to a full understanding of the context of the system in relation to the overall activities of the entity. It is therefore necessary to summarise data such as:
  - Number of transactions(eg. Number of concluded contracts);
  - Value of transactions; and
  - Seasonal fluctuations.
- Forms used to evaluate the system.

It may also be useful for the auditor to know the number of employees or an analysis of the transactions by value or age to assist in the evaluation of risk when a weakness is highlighted.

#### **2.1.2.4 Step 4 – Check the system is recorded correctly**

It is important to ensure that the system is recorded accurately because it provides the basis for an evaluation of internal controls and for deciding on a programme of audit tests.

##### ***Walk-through testing***

In conducting 'walk through' tests, the auditor looks primarily for evidence of the existence of controls. This may involve examining a small number of different transactions at each stage of the process or following one transaction through from start to finish. The aim of this type of testing is to make sure that the system works in the way it is described in the systems narrative or flowcharts and to confirm the controls in place at each stage.

Normally transactions are followed from start to finish (final processing) – known as "cradle to grave". However, sometimes it is more convenient and practical to start from completion of processing. It is important to consider documents which pass through any sub-systems (eg overtime payments in a payroll system) and to look carefully at each file of documents and ask yourself why they are kept and where they are kept.

##### ***Verify the system with management***

It is often useful to discuss your understanding of the system with management and to obtain their agreement with your record of the system. This will help to avoid unnecessary discussion or debate at a later stage in the audit. In some cases it may be appropriate to ask the manager to signify agreement to your record of the system in writing.

*What to do with differences between the systems record and the walk-through test.*

When this happens there are two possible reasons:

- The system record you have prepared is wrong, or
- The system record is correct but the system is not working properly.

If there is a difference, or any other information is identified which is inconsistent with the flowchart, you should refer back to the original source(s) of the information before doing any more work. This is important because, if the system record has to be amended the paths for the transaction walk-through may have to be changed.

When the difference is the result of a breakdown in the system, you will normally need only to record this fact on your working papers. This information should then be taken into account in the evaluation of internal control.

## 2.1.3 2.3 EVALUATING THE SYSTEM

### 2130 A1 - Control

The internal audit activity must evaluate the adequacy and effectiveness of controls in responding to risks within the organisation's governance, operations and information systems regarding the:

- Reliability and integrity of financial and operational information;
- Effectiveness and efficiency of operations and programmes;
- Safeguarding of assets; and
- Compliance with laws, regulations, policies, procedures and contracts.

### Step 1 - Identify and Record the Risks and the Actual Controls

Once you know how the system works you need to review the control objectives you identified at the planning stage of the audit to establish whether they are appropriate and whether additional control objectives are needed.

When you are satisfied with the list of control objectives you then need to prepare a separate 'Control evaluation record' for each control objective.

After that you should identify:

- The risks relating to each of the control objectives, and
- the actual controls operated in that system. These should be shown clearly in the systems description you have prepared.

#### *Identifying risks*

The internal audit evaluation should take account of the likelihood of undesirable events occurring (risk) and their significance to the organisation (materiality). Internal auditors should use their judgement to determine what level of control is appropriate in the light of their evaluation of the risks and materiality involved.

Risk may be viewed as the chance (or probability) of one or more of the organisation's objectives not being met. When you are identifying risks it is important to remember to keep the control objective in mind at all times. The risks you are looking for are those that might impact upon the achievement of the control objective. Try to be sensible and realistic about the risks you include. Identified risks should be recorded in Column 1 of the 'Control Evaluation Record' shown below.

Materiality is an assessment of the significance of a failure to achieve the objective. Materiality may be measured in terms of the financial consequences, the relative importance of the objective concerned, or the sensitivity of the areas concerned. In considering materiality, internal auditors should take into account: the possible direct and indirect financial consequences; the importance of particular management objectives in the context of the organisation's overall objectives; the potential for embarrassment or adverse publicity. Internal auditors should also take into account the cost of reacting to a failure, as well as the effects of the potential failure itself. Such costs may

include the costs of any investigation, taking corrective action and supplying appropriate explanations to the regulatory authorities, if relevant.

For each risk you identify you should decide whether the level of risk is 'High', 'Medium' or 'Low' and note that in Column 2 of the 'Control Evaluation Record'.

Where appropriate, and when time allows, the risks identified should be discussed and agreed with management.

Typical categories of risk are:

- **Error** – is there a possibility an error could occur during the process in question or that information held in a key data file or store (eg details of supplier; employee records) could contain errors. Eg. Tender documentation provided to suppliers does not include all the information they need.
- **Fraud** – could the process or information be deliberately manipulated for personal gain which might go undetected? **Ex.** *Employee is in the position to award a contract in return for payment in cash, assets (cars) or services (holidays).*
- **Theft** – in the delivery of the systems objectives and the performance of the activity under review are there physical assets which someone could remove for personal benefit? **Ex.** Laptop computers which are not locked away could be taken from the office
- **Regulatory** – could the process or system fail to meet international and EU laws, rules and regulations; the laws of Montenegro and any rules and regulations laid down by the central government or the municipality? **Ex** *Risk that Guidelines for preparing the financial plan for indirect budget beneficiaries issued by DBBs are not in accordance with the Guidelines on budget preparation issued by the MoF*
- **Disclosure** – is there a possibility of unauthorized disclosure of information or of the way in which the system or process operates which might lead to loss, embarrassment or other disadvantage? **Ex.** *Important information for public procurement are disclosed before the Public procurement Committee opened bids or the name of the bidder who won the award is disclosed before the procedure is completed*
- **Disruption** – is there a possibility of loss or disruption which would make it difficult or impossible to operate the system or process or could lead to the loss or corruption of data. **Ex.** *The existing software for additional/support books-recordings is attacked by a computer virus, and the last regular back-up was done two months ago – resulting in a lack of valid data for report preparation*
- **Value for Money (VFM)** – is there the possibility of uneconomic, inefficient or ineffective use of resources in the performance of the process or system? **Ex.** *Is it the right moment to invest in adaptation of objects in one area of culture when there is an evidence on other object more in danger in some other area*

Alternatively, the following risk prompts can be used to identify risks. They can help to stimulate ideas of what could go wrong within a system, what impact it could have and how likely it is to occur.

- Failure to ...
- Missed opportunity for ...
- Ineffective ...
- Inability to ...
- Reliance on ...
- Inadequate ...

- Delay in ...
- Incompatible with ...
- Loss of ...
- Non-compliance with ...
- Lack of ...
- Conflict between ...
- Inappropriate ...
- Disruption to ...
- Increase in ...
- Concentration of ...
- Inconsistent ...
- Reduction of ...





### Control evaluation record

Prepared by: .....

Date: .....

Working paper number: 10/1

Reviewed by: .....

<b>Risk/Control Evaluation Record</b>						
<b>Control Objective:</b> To ensure that suitable procedures exist for placing new starters on the payroll						
<b>1. Risk</b>	<b>2. Risk level H/M/L</b>	<b>3. Control</b>	<b>4. Control Adequate?</b>	<b>5. Test Reference</b>	<b>6. Control Effective?</b>	<b>7. Comments</b>
1.1 The wrong people could be put on the payroll	M	A list of the names of all new starters added to the payroll is produced monthly and reviewed by the Head of Payroll Section	Yes			
1.2 The required checks on new starters may not be made (certificates, references etc)	M	A checklist for action required when appointing new staff should be completed by Recruitment section and sent to Payroll Section.	Partially	WP15/1	No - Tests showed that the checklist is sent to Payroll Section, but that it is frequently filed without any review	
1.3 The wrong salary could be paid	M	The monthly check of the list of names of all new starters by the Head of Section	No	WP15/2	No – tests of the list of names show that they do not contain any salary details.	
<b>Conclusion:</b>						

### **2.1.3.1 Step 2 – Identify the actual controls in the system**

Controls are actions and procedures established by the auditee to ensure that the objectives of a system are met. Based on the systems description you have prepared you should then identify the **actual** controls that exist in that system in respect of each of the risks you have identified. These actual controls should be recorded in column 3 of the 'Control evaluation record'. **Remember** that for some risks more than one control may exist.

The actual control should be adequately described, cross referring to supplementary notes if necessary. If a control is absent from a particular area then this fact should be recorded on the 'Control Evaluation Record', instead of a control description.

One simple way of identifying what the actual controls in a system are, is to use the following categories of control to prompt your ideas:

- **Segregation of duties:** the functions of authorising transactions; recording the transactions; and custody of the associated assets should be undertaken by separate staff;
- **Organisation:** there should be a clear organisation chart and all staff should have up to date job descriptions that clearly indicate their responsibilities;
- **Authorisation and approval:** all transactions and decisions should be formally authorised by nominated staff;
- **Physical:** there should be suitable controls over access to offices, assets, controlled stationery, and computer systems;
- **Supervision:** all staff and activities should be adequately supervised by someone who understands the process and will detect deviations from accepted practice;
- **Personnel:** appointment of staff should be adequately controlled; all staff should be suitably trained for their post and appraised regularly;
- **Arithmetical and accounting:** checking / re-performing tasks carried out by others; costing (adding up) orders, invoices, payroll etc; reconciliation between the bank and accounting records; control accounts; and
- **Management:** production of suitable financial and operational management information; use of exception reports; critical review and enquiry by management.

Further guidance on types of control is given in Appendix B

### **2.1.3.2 Step 3 – Evaluate the actual controls in the system**

Once you have identified the controls that actually exist you can then go on to assess whether these controls are likely to be adequate. However, you need to remember that internal auditing is not simply a series of stages that can be completed one after the other. When you go on to test the controls you have identified, you may discover that there are additional controls or that some

controls are not actually operating as expected. If so, you will then have to go back and revise your system description to ensure it reflects the actual controls that are operating in practice.

Internal auditors obviously want to see controls are in place, but they need to be there for a purpose – that is to ensure that the system or process achieves its objectives. Controls are only needed to reduce the risks to the achievement of these objectives to an acceptable level. This means that there may be circumstances when internal auditors suggest that certain controls should be removed, for example, if they are unnecessary or they do not really help to reduce the level of risk.

At this point in the audit you will need to make an assessment of the system and each of controls in that system to establish the ADEQUACY OF CONTROLS.

### *Assessing the Adequacy of Controls*

This requires the auditor to consider each control objective in turn to establish whether or not each control objective will be achieved by the actual controls which have been identified. This often involves using 'audit judgement'. Just because a particular control is specified in the law or in the system manual does not necessarily mean that it is adequate in the particular system being audited.

At the same time you should also consider which of the actual controls in place are most likely to ensure that the control objective will be achieved. It is normally only those controls that should be tested. The decision whether or not to test each control should be recorded in Column 4 of the 'Control evaluation schedule' and, if applicable, the test reference should then be recorded in Column 5 of the 'Control evaluation schedule'.

If the internal auditor, after initial evaluation, concludes that a control is not effective or is not required (whether because it duplicates another control or it doesn't actually ensure achievement of the control objective) there is no point in testing this control – and this fact should be recorded in Column 5 of the 'Control evaluation schedule'.

### *Compensating controls*

There will be occasions when controls you expect to find are missing. If this happens, you should search for controls that compensate for this potential weakness. For example, in auditing a purchasing system one control objective might be that "procedures for ordering, payment and recording of expenditure are properly documented and complied with", but in practice there are no procedure manuals (an expected control to meet the objective). However, the staff that operate the system are all highly experienced and knowledgeable, and are closely supervised. In these circumstances, internal auditors may consider the experience and knowledge of the staff and the level of supervision adequately compensate for the absence of manuals, and thus they may conclude that the control objective is adequately achieved despite the absence of such manuals.

Internal auditors should evaluate each existing control to consider whether it is adequate. In addition, they should evaluate the whole spectrum of controls that may help to ensure that a particular control objective is achieved.

## 2.1.4 2.4 TESTING THE CONTROLS IN THE SYSTEM

### 2.1.4.1 *Effectiveness of Controls*

Testing the operation of the actual controls enables us to establish whether or not the control is being operated both effectively (ie that is doing what it is intended to do) and consistently.

Audit testing can be a very time-consuming part of the audit process, sometimes taking up to half the time available for the audit. This means it is important to ensure:

- audit tests are carefully planned
- there is adequate evidence of the testing which has been done, and
- audit conclusions can be fully supported by the testing done.

Internal auditors use testing to evaluate the operation of the system and to form or corroborate an opinion about the adequacy or otherwise of control. This is done by measuring particular characteristics of selected transactions or processes and comparing the results with those expected.

Tests of control are conducted to provide evidence about the effective operation of the internal control systems. However, please remember that:

- **not all controls need to be tested**, and tests should normally be limited to those controls identified during the assessment of the adequacy of the controls (see above)
- some controls contribute to the achievement of more than one control objective, and may therefore appear on the 'Control evaluation record' more than once. Clearly such controls, if selected, should only be tested on one occasion (i.e. **not** each time they appear on the 'control evaluation record').

It is also important to understand that it is the way the control works, and not the accuracy of the underlying transactions, that is being tested. In general, there should be evidence that controls are being performed. For example: with controls over document streams (eg purchase orders), the evidence may be the authorising officer's initials or, for periodic controls such as bank reconciliations, the evidence may be the reconciliation itself. The test should be designed to check that this evidence is present.

### 2.1.4.2 *Step 1 – prepare Test Programmes*

Using as a basis the Control Evaluation Records you have completed, a Test Programme (TP) should be prepared for each control objective. Guidance on the nature and extent of any testing is given below. Keep in mind that, normally, testing will only need to be done for each of the risks for which there is no control in place or where the control that is in place is considered to be inadequate.

It is important to remember that controls are not necessarily a good thing in their own right, and that they should only be tested as long as they are considered to have a significant impact on the success of the system. Thus the testing undertaken should reflect the overall nature of the system, your understanding of it and whether there are compensating controls in place.

The testing you do should establish whether a particular control:

- really does provide reasonable assurance that the control objective is achieved, and/or
- that it will reduce the potential risks of not achieving the control objective to acceptable levels.

A form for recording test programmes is set out below.

**INTERNAL AUDIT DEPARTMENT**

---

**TEST PROGRAMME**

---

**Control Objective 1: To ensure that tender documentation is properly prepared and is handled in a way that ensures bids submitted are appropriate and correct.**

<b>Test (Note 1)</b>	<b>W/P Ref.</b>	<b>Test Results (Note 2)</b>	<b>Signature /Date</b>	<b>Substantive Tests (Note 3)</b>
1.1. Confirm by review of files and enquiry that no member of staff is involved in both the preparation and approval of tender documents.		Discussions with staff and review of 3 tender files indicated that there is adequate segregation of duties.		
1.2. Examine two current tender documents to ensure that they contain all the appropriate documents and elements as per public procurement requirements.		Checklist of documents submitted by tenderer missing in respect of one tender. Checks extended to three more files revealed no similar discrepancies		

Test (Note 1)	W/P Ref.	Test Results (Note 2)	Signature /Date	Substantive Tests (Note 3)

**Note 1:** The Test column should contain a brief outline of the test to be carried out, including the number of documents etc to be tested and the precise objective of each test.

**Note 2:** The Test Results column should provide a brief summary of the result of the test. More detail will be contained in the relevant working papers.

**Note 3:** The Substantive Test column will only be used in exceptional cases –eg where it appears from the initial tests that there is a significant lack of control or a major breakdown of control. In such cases it may be appropriate to carry out a higher level of testing.

### Things to consider when deciding on the tests to include in your Test Programme

There are three main things to consider when you are developing test programmes: the type of test; the sample size and the testing technique to be used.

#### A - Type of test

The first thing is to decide on the type of test to be carried out. There are three main types of testing – compliance, re-performance and substantive testing.

*Compliance testing* The aim of compliance testing (i.e. test of controls) is to confirm that existing controls are operating as intended and are reliable and effective. An example is checking that each invoice has been initialled to indicate that it was authorised by an appropriate manager. The primary aim of compliance tests is not to identify errors, mistakes or potential fraud, but to identify controls that are not always performed as required. The reasons for any errors or omissions and the reliability of controls are more important to internal auditors than any individual mistakes or omissions. **Compliance testing should be the default type of testing to be used during systems auditing.**

*Re-performance testing* is necessary to confirm the quality of the control in operation. While compliance testing provides evidence that controls have operated it is necessary to ensure that the control is operating as designed. For example, while evidence of management review may be present in the form of a signature on a document, it is still necessary to re-perform that control to ensure that it is being operated correctly.

*Substantive testing* is intended to enable a conclusion to be reached on the completeness, accuracy and validity of information and records. It is concerned with outputs rather than the adequacy of controls and therefore has a limited role to play in system based auditing. It is, nevertheless, sometimes used as a means of demonstrating the existence or seriousness of weaknesses – for example where little or no control exists or when the auditor is unable to convince management by any other means. It is also used in financial auditing when it is necessary to confirm figures and balances in the accounting records.

## B – The size of the test sample

### *Sample sizes*

Most systems-based audits will involve the use of sampling for testing. Next you need to decide on the size of the test sample. Those samples should be selected from a whole set of data (the population). The population needs to be defined in advance as it affects the selection of items and the evaluation of results. A sampling unit is any of the individual items that constitute the whole relevant population.

In order to be representative of the population, the sampling units to be examined should be selected at random. Audit staff are encouraged to select samples on a statistical basis, where this is practicable. It is unlikely, however, that available audit resources will allow this in which case a quasi-random selection method is recommended – the selection of records to be tested should be done without any intended bias towards a particular section of the population or time period.

In general, the sample size depends on the frequency with which the control is operated. For example, some controls are operated daily or over document streams (e.g. authorising invoices) while others are operated weekly or monthly (e.g. performing reconciliations). There is also a smaller sample size for systems, which are not considered material to the financial statements (and are being considered on a cyclical basis as part of the wider corporate governance responsibilities).

It is recommended that the following guidance is adopted for determining the sample sizes to be used. On some audits it may be necessary to select larger samples, but that should only be done with the approval of the Head of Internal Audit.

	<b>Sample Size</b>	
<b>Frequency</b>	Systems material to the financial statements	Systems subject to cyclical review
<b>Daily</b>	30	15
<b>Weekly</b>	5	5
<b>Monthly</b>	2	2

Internal auditors should consider the following points when selecting a sample of transactions to test:

- The sample should be selected from the total population, for example, when testing that all payments have been authorised the sample should be selected from a bank statement or payments register rather than from a file of paid invoices;
- The period covered by the sample should be appropriate. This should normally be the period since the last audit of the system. However, the sample should be weighted towards the current financial year, especially if the last audit was several years ago. If the system has changed significantly, the sample should only include the period since the changes were introduced;
- The method of sample selection should be recorded. The sample should include all significant types of transaction; and

Testing should be focused on high-risk areas.

### *The use of substantive testing*

As a general rule substantive testing is only used in exceptional cases by internal audit.

Substantive tests are carried out in order to gather evidence on the completeness, accuracy and validity of information contained in the accounting records. The need to conduct substantive tests on underlying transactions depends, in part, on the assessed level of control risk. Control risk is the risk that a material fraud or error, or other significant matter will not be prevented or detected because of weaknesses in the accounting and internal control system. Audit staff, of the appropriate seniority, should assess the level of control risk based on the results of the preliminary assessment and the test of control carried out. This assessment is a matter of professional judgement, but the following may serve as a general guide:

Test of	Control Results		Indicative Level of Control Risk
Sample size	30	15	
Number of Failures	0	0-1	LOW
	*1-2	2	MEDIUM
	>2	>2	HIGH
Preliminary Assessment	HIGH		
Control absent			

*\* It should be noted that where one error out of a sample of 30 is found, audit staff have the option of assessing control risk as medium or conducting a further 30 tests. Provided no further errors are found in the additional sample, control risk may be assessed as low.*

Substantive testing is concerned with the accuracy and completeness of outputs rather than the adequacy of controls. An example is checking that the amounts paid are the same as the value on the invoice. **Substantive testing, therefore, should have only a limited role to play in systems auditing.** Nevertheless, internal auditors sometimes use it as a means of demonstrating the existence or seriousness of weaknesses, when they are unable to convince management by any other means. Internal auditors should bear in mind that substantive testing is usually not economical and may weaken their arguments if it fails to produce evidence of actual errors. In most cases, satisfactory results from the testing of a particular control may preclude the need for any substantive tests to be undertaken in that area. Substantive tests should be carried out, however, in areas where the audit risk is of a sufficient level to warrant it. This may be due to:

- No control being in place to address a particular control objective and
- Tests of control showing that a control is either not operating or that the incidence of failure is sufficient to give cause for concern.

#### *Conducting substantive tests*

Conducting tests of control is relatively straightforward, as the evidence of the control operating is generally a signature or initial or perhaps simply the existence of a document. For substantive tests, forming an opinion on the reliability and appropriateness of the available evidence is more involved. Audit staff should, in examining assets, documents or accounting records, avoid accepting them or any supporting explanations at face value, and should bring to bear a reasonable amount of professional scepticism.



Audit staff test only a sample of the transactions of an audited body and there is inevitably a risk of either giving an inappropriate audit opinion on the financial statements or not reporting a significant matter concerning the wider public sector audit responsibility.

## **C – The testing technique(s) to be used**

There are a number of different ways that internal controls can be tested. Internal auditors should seek to use the most cost-effective source of evidence on the reliability of each control to be tested. The nature of the control will influence the way auditors test it, and there are five main methods of testing:

- Observation is particularly important where there is no permanent record of activities – discrete observation can reveal whether there is improper access to a restricted area;
- Interviewing is useful when evidence is absent or unclear. Care should be taken because the behaviour of the auditor could affect the attitude of the person being interviewed and an insensitive approach could lead to an un-cooperative and defensive reaction;
- Verification involves independently confirming the truth, accuracy, or validity of transactions. However, the internal auditor's prime role is to evaluate and test the controls, not to confirm the validity of the data itself. When using verification tests, auditors should ensure that they are related to the operation of controls. Methods used are:
  - Comparison - with some ascertainable fact or standard, e.g. that instruction manual are up-to-date or staff have attended appropriate training courses at prescribed intervals;
  - Confirmation - checking statements of performance, e.g. checks with customers that supply delivery response times are as stated by the supplier; and
  - Vouching - checking a transaction against supporting documentation, e.g. a payment to a supplier against the corresponding order and goods received note.
- Reperformance is particularly relevant where calculations or measurements have been supposedly checked as a control and the auditor wishes to check that the control actually operated;

Analytical review consists of reviewing the reasonableness of significant ratios, trends or other data. For example, a comparison of the ratio of payroll costs to the number of employees over several months. Thus it is primarily a substantive test but it may provide evidence of the quality of the general control environment.

Guidance on the possible tests for each of the main financial systems are to be developed by CHU.

### **2.1.4.3 Step 2 – Carry out the tests set out in the TP**

When carrying out the tests it is important that those tests are adequately recorded. A separate working paper should be prepared for each test and should show:

- the purpose of the test
- details of the test carried out – sample size and details of the sample (dates; documents reviewed; serial numbers etc)
- what was actually checked
- results (findings) of the test
- conclusions.

The results of the test should be recorded on the TP and also on the Control Evaluation Record in Column 6 ('Effectiveness of Control'). Where appropriate, additional comments should be inserted in Column 7 of the Control Evaluation Record.

It is important to keep in mind that a 'failure' when testing is any item where either the expected evidence is not present or the control has otherwise been found not to operate. Audit staff should be concerned with what the failures infer about the effectiveness of the relevant controls and the related potential scope for fraud and error. Any failures should be investigated by audit staff as it may be possible to localise the cause e.g. if they only occurred when a particular employee was on holiday. In general, the value of any error arising from the failure is not in itself important because, at this stage, it is the control (not the transaction) that is being tested.

## 2.1.5 2.5 ARRIVING AT AUDIT CONCLUSIONS

### **2320 Analysis and Evaluation**

Internal auditors must base conclusions and engagement results on appropriate analyses and evaluations.

This is the stage of a system based audit where the auditor considers the results of all the work you have done before preparing the draft report. However, it's not limited to this stage and it's important that you think about your findings, conclusions, and possible recommendations throughout the evaluation and testing stages of the audit.

#### **2.1.5.1 Audit findings form**

The Audit Findings Form (see below) provides a useful structure for handling the information you have obtained and to think things through in a logical way when writing the audit report. It is designed to help you to establish the causes of the issues or weaknesses which have been identified from the evaluation of the system of control, and to develop suitable recommendations.

It should be completed as you are doing your testing when the nature and significance of control weaknesses are established. Wherever possible try to group related weaknesses together on the Audit Findings Form. This will make it easier to plan your audit report.

#### **2.1.5.2 Completing the Audit Findings Form**

##### ***Issue/Weakness***

This should reflect the issue or weakness identified by audit tests. It is not necessary to provide a lot of detail - a description of only one or two short sentences will normally be enough. For example: 'procurement invoices are not arithmetically checked before being approved for payment'.

##### ***Causes***

It is important to identify the real underlying cause, and not the symptom, of each weakness. If you don't do this it is unlikely that your recommendation will result in improved control. When completing this section of the form you should ask yourself:

- 'Why is this happening or not happening?'

##### ***Effects***

Here you should record the actual or potential impact of the weakness you have identified. This could include: increased cost; delay; inability to make 'good' decisions because information is not available; failure to meet targets or objectives; loss of control over documents etc. Your audit tests will provide you with the information you need to determine the effects. If possible, try to quantify

what the effect might be. This will allow you to make a stronger case and help to convince management of the need to implement your recommendation. It is also worth considering

- What is the effect on performance, control, efficiency etc.?
- Why do management need to know this?'

### ***Audit file reference***

This is a simple cross reference to the working papers which provide the detail and supporting evidence for the weakness.

### ***Conclusion***

A brief conclusion should be given in respect of each weakness. It should normally be only one or two sentences which sum up the situation.

For example: 'the failure to check invoices arithmetically makes it impossible to be certain that the correct amount is being paid to the supplier. This could result in the organisation paying more than it should for goods and services'.

Setting out the conclusion in this way can also be helpful when you are writing the audit report.

### ***Recommendations***

You should note down the **main elements** of your recommendations. Keep in mind the causes of the weakness and make sure that your recommendation will deal adequately with each of them. The recommendations internal auditors make may include the following:

- Introducing further controls;
- Refining or amending existing controls to make them more effective;
- Ensuring that existing controls are applied regularly and consistently;
- Reducing unnecessary controls; and
- Introducing best practices.

Further guidance on arriving at conclusions is given in the Audit Report Writing section of Section 2.6 below.

Using this form will help you in your exit meeting with management (further guidance on handling exit meetings is given in Appendix A) and provide you with a good basis for discussing your conclusions and recommendations. It will also aid discussion of any alternative solutions to issues and weaknesses which may be suggested by the auditee.

It is also good practice to discuss your findings informally with management before starting to draft the audit report, and the form can help you to do this.

The following is an example of how to use the Audit Findings Form

#### **Payroll system**

- Weakness – there is no procedure to ensure that all new employees are correctly entered onto the payroll;
- Causes:

- Lack of feedback to Personnel by Payroll Section, and
  - No independent check of all new starters within Payroll section.
- Effects:
  - A new employee could be put onto the payroll at the wrong time and at the wrong point on the salary scale;
  - The organisation will pay the incorrect salary;
  - Poor initial impression given to the new employee; and
  - A 'ghost' employee could be put on the payroll.
- Conclusion – this is a significant weakness that provides scope for error or deliberate manipulation of the payroll.

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### AUDIT FINDINGS FORM

Working Paper Ref.No. ....

<b>Audit:</b> 1/2011			<b>Financial Year:</b> 2011		
<b>Prepared by:</b>			<b>Date:</b>		
<b>Reviewed by:</b>			<b>Date:</b>		
Weaknesses	Causes of weaknesses	Consequences of weaknesses	Audit File Ref. No.	Conclusions	Recommendations
1. Some personal files are incomplete	<ul style="list-style-type: none"> <li>- failure to check that all necessary documents are on the file prepared for each new employee</li> <li>- Difficult for staff to update and check files because the files are not located near to where they work</li> </ul>	<ul style="list-style-type: none"> <li>- validity of the appointment may be questioned</li> <li>- new employee may be appointed on wrong terms and conditions</li> <li>- difficulties could arise if it becomes necessary to terminate the employee's appointment</li> </ul>		Inadequate employee records could result in the wrong payments being made, and could lead to confusion over the exact status of the employee at some future date.	All new employee files should be reviewed for completeness and accuracy before they are filed. A checklist at the front of the file might assist this process.
2.					

## 2.1.6 2.6 AUDIT REPORTING

### **2400/2410 Communicating Results**

Internal auditors must communicate the results of engagements.

Communications must include the engagement's objectives and scope as well as applicable conclusions, recommendations and action plans.

### **2440 Disseminating Results**

The head of internal audit must communicate results to the appropriate parties.

#### **2.1.6.1 Introduction**

This section of the Audit Manual is concerned with reports on individual audit assignments. It covers:

- The purpose and function of an audit report;
- The types of audit reports and alternatives to them;
- Some guidance on the structure and content of audit reports.

Audit reports should provide an assurance on the system under review; and form the basis of the overall assurance on the internal control system to be provided in reports to the head of the organisation.

It is vital to remember that the audit report is the only tangible product of an audit and, as such, is Internal Audit's 'shop window'. It is the culmination of the planning, time and effort which goes into an audit, and reflects the quality and thoroughness of the audit. The quality of the report will have an important influence on the view of internal audit held by senior management of the organisation. An inadequate audit report may negate the best audit work and finest conclusions. It may also damage the reputation and status of Internal Audit.

#### **2.1.6.2 Purpose and functions of an audit report**

The principal objectives of audit reports are:

- To communicate the problems identified and the causes of those problems;
- To explain the effects and repercussions of those problems and quantify them where necessary;
- To measure performance - by providing analyses and appraisals - and to highlight areas in which greater efficiency and effectiveness may be achieved, and waste eliminated;
- To convince management of the need for change;
- To suggest practical and cost effective solutions;
- To provide a basis for follow up to ensure that appropriate action has been taken.

There are three main functions of an audit report. First, it is an *action document* - unless the report achieves action it will have been a waste of time for everyone involved in the audit. To achieve action the report should provide the client with a brief, objective assessment of control in the area

under review and highlight any significant weaknesses identified. It should also bring out the impact of those weaknesses on the level of control and demonstrate to management that they need to do something about it:

- By explaining the risks involved, and
- By quantifying, where possible, those risks and any potential benefits.

Second, it acts as a *formal, permanent record* of: the audit work undertaken and the conclusions drawn from it, and the level of control which exists in a particular area at a specific point in time. Finally, a good report - by communicating professionalism and competence - *demonstrates Internal Audit's objectivity and independence* and shows that auditors can help to improve efficiency and effectiveness.

### 2.1.6.3 Types of audit report

A written report should be issued after each audit to provide a formal record of the results of the audit. There are basically two types of audit report which can be considered - a Standard Report and an Audit Memoranda.

*The Standard Report* is the type most frequently used. It comprises three main sections - the Executive Summary, the Action Plan, and the Detailed Report.

*Audit Memoranda* are normally shorter than Standard Reports and are used:

- For quick and special reviews carried out at the request of management to report the results of follow-up audits;
- Where only relatively minor points arise from the audit;
- As an interim report on longer audits.

An alternative to an audit report is a *Presentation* or oral report. This involves a formal verbal presentation of the audit findings and discussion of the action to be taken by management. The advantages and disadvantages of reports and presentations are set out in the table below.

Presentation Method	Advantages	Disadvantages
<b>Presentations</b>	<ul style="list-style-type: none"> <li>• Interactive</li> <li>• Flexible</li> <li>• Can help gain acceptance</li> <li>• Aid discussion of complex issues and solutions</li> <li>• May increase chance of action</li> <li>• Can focus on high priority issues</li> <li>• Internal Audit can influence action</li> </ul>	<ul style="list-style-type: none"> <li>• Can't put across all the evidence</li> <li>• Can be difficult to communicate complex data leading to misunderstandings</li> <li>• Need facilitation skills and two people</li> <li>• Need to be well prepared</li> <li>• May be dominated by one individual or issue</li> <li>• Auditee may still want report</li> </ul>



<b>Standard reports</b>	<ul style="list-style-type: none"> <li>• Good for detailed evidence and complex data</li> <li>• Can provide background and context</li> <li>• Evidence is readily available to reader</li> <li>• Some auditees prefer them - more 'authoritative'</li> </ul>	<ul style="list-style-type: none"> <li>• Can be time-consuming to produce</li> <li>• Long reports may not be read in full</li> <li>• Sometimes too much to assimilate</li> <li>• Can be untimely due to delays in preparation</li> </ul>
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#### **2.1.6.4 The structure of audit reports**

The precise structure of audit reports should be decided by the Head of Internal Audit. The important thing is for every audit report in each organisation to have the same 'house style'. This makes it easier for line management to use and understand them and helps to build up an image for the internal audit unit.

Audit reports – typically should contain:

- Report Cover;
- Contents page;
- Executive Summary;
- Action Plan;
- Detailed Report;
- Appendices/annexes.

Guidance on the detailed content of each of the sections in standard audit reports is given in the following sections.

#### **The Report Cover**

This should set out the report title, date of issue and report number. Some audit units adopt logos which are printed on the cover. It may also be worth considering the use of different colour covers for different types of audit review (systems, VFM etc).

#### **Contents Page**

This should include the report title, details of each of the main sections of the report and a list of all appendices.

#### **The Executive Summary**

The Executive Summary should stand alone and convey the main points to the reader without the need for them to refer to the Detailed Report. It should enable senior management to establish quickly and easily:

- The scope and main objectives of the audit;
- Why it was done;
- The nature and scale of the system or activity reviewed;
- The main conclusions of the audit, and
- The principal recommendations.

This is the most important part of the report. It is the main opportunity to encourage the reader to look at the Detailed Report and either take action, or ensure that appropriate action is taken. It should not normally be more than three typed pages in length and should include the following sections.

**Introduction and background** – covering:

- Appropriate details of the area under review, including an indication of the significance or value of the topic/system and any significant or unusual aspects of which the reader should be aware;
- The scope and principal objectives of the audit;
- Any important areas excluded from the review, and why
- When and why it has been audited.

**Main Conclusions** - which should paraphrase the most important conclusions reached in the Detailed Report. These are often set out on a section by section basis, but sometimes it can be more effective to identify any common ‘themes’ which run through the report. Any overall opinion must reflect accurately the findings and comments in the Detailed Report. Keep to the major issues arising and try to avoid raising any minor conclusions in this section.

**Principal recommendations** - this should list only the key (high priority) recommendations that feature in the Action Plan and each of them should relate to one or more of the main conclusions.

The key thing to remember is that the Executive Summary should stimulate interest which will lead to action.

**The Action Plan** – should be placed immediately after the Executive Summary and list all the recommendations contained in the Detailed Report (see section 4)

## **The Detailed Report**

### **Format**

The main body of the report should be divided into suitable sections, each clearly headed, e.g. “Placing purchase orders”. The order of the sections will be determined during the report planning process. It may reflect the relative significance of the audit findings, a chronological sequence or simply follow the order in which events occur in the system.

Normally recommendations should be placed at the end of each section. However, if a section is particularly long, and/or deals with a variety of issues, recommendations can be inserted at appropriate points in the section. Recommendations should be placed in a separate paragraph(s) preceded by the subheading “**Recommendations**” in bold type.

### **Content**

Each section should contain details of the relevant findings. It is important to highlight the underlying causes of weaknesses and their impact on performance or the level of control. Failure to do so is one of the biggest single weaknesses of audit reports. Ask yourself:

- “Why is this happening or not happening?”;
- “What is the effect on performance, control, efficiency etc.?”;
- “Why do management need to know this?”.

Recommendations should be included which deal with those underlying weaknesses.

Descriptive material should be restricted to what is needed to establish the nature and extent of any weaknesses identified. It is not necessary to provide full and detailed descriptions of every part of the system under review.

It is often useful to include graphs, tables, and charts to quantify and illustrate facts and data. Beware of overusing graphs etc, as this can obscure the message and sometimes irritate the reader.

The report must be factual. Subjective comments are not acceptable. Where it is necessary to make value judgements or assumptions, their basis should be clearly stated.

Avoid the use of long paragraphs wherever possible.

Don't be afraid to say when something is being done well, or to refer to good points you have found. Be careful you don't overdo this.

## **Recommendations**

In developing your recommendations there are some simple things that you should try to remember. They should:

- Be based on reliable information;
- Deal with the underlying cause of the problem, and not just the symptoms;
- Describe precisely what needs to be done;
- Suggest who should be responsible for taking action;
- Be clear, concise and simple;
- Be unambiguous;
- Be achievable;
- Refer to a discrete action point - i.e. each recommendation deals with a single point.

Where an auditee has already taken action, or agreed to do so, this should be stated in the report.

## **Paragraph** numbering – some simple rules

Reports should adopt a simple one-part numbering system (1; 2; 3 etc) beginning with the Executive Summary and continuing to the end of the report. Every paragraph should be numbered.

Recommendations should be numbered (R1, R2, R3 etc) so that they can be readily identified.

Headings and sub-headings should not be numbered.

## **Finalising the report**

Before finalising your report there are a number of key checks you need to make. At the very least you should ask yourself the following questions:

- 1) *The Executive Summary*
  - a. Does it motivate the reader to want to read the detailed report?
  - b. Do the main conclusions reflect accurately the major issues and conclusions contained in the detailed report?

- c. Does each key recommendation relate to one or more of the main conclusions?

2) *The Detailed Report*

- a. Are the conclusions appropriate and meaningful?
- b. Are weaknesses and benefits quantified where appropriate?
- c. Is the need for corrective action sold? Have you explained the effects of the issues you have identified? Use the “so what?” test.
- d. Do your recommendations deal effectively with the underlying causes of the problem?

3) *General*

- a. Is the tone of the report appropriate?
- b. Where appropriate and possible have you tried to be positive?
- c. Is the report easy to read and understand?
- d. Have you deleted all unnecessary words and phrases?

You could also use the following checklists to help ensure you produce high quality draft and final reports.

#### **2.1.6.5 Audit report quality assurance checklist**

##### **Report content**

		<b>Draft</b>	<b>Final</b>	<b>N/A</b>
1.	The audit report includes:			
	• transmittal letter			
	• title page			
	• table of contents			
2.	The audit report contains an executive summary (2/3 pages maximum)			
3.	The detailed report includes:			
	The purpose of the audit, including the origin/source, as appropriate			
	The scope of the audit, including time period covered, functions or processes reviewed, and audit techniques used, as appropriate			
	Background information describing- the activity:			
	• the audit result			
	• the audit finding			
	• the audit conclusion			
	• the audit recommendations			
	• the action plan			
	• all the correct appendices			
4.	A draft report is clearly labelled 'draft'			

##### **Report quality, tone, and appearance**

		<b>Draft</b>	<b>Final</b>	<b>N/A</b>
1.	The report is clear and concise, free of unnecessary detail			
2.	The conclusions expressed in executive summary and the body of the report are consistent			
3.	Report is broken into sections and each is clearly labelled			
4.	Descriptions of operating procedures, if required, are kept short and concise			
5.	The structure of the report is logical and easy to follow			
6.	Jargon, technical language, clichés, and colloquialisms are avoided			
7.	Acronyms and abbreviations are defined before being used			
8.	Active voice predominates			
9.	The report is direct and to the point			

### Report quality, tone, and appearance (continued)

		Draft	Final	N/A
10.	Headings are informative and descriptive			
11.	Opening sentences are strong and attention-getting			
12.	Main points are presented first			
13.	The report has a balanced tone			
14.	Findings are worded constructively			
15.	Recommendations are directed toward achieving desired results without prescribing step by step actions			
16.	Report has a professional appearance			
17.	Spelling ,grammar and punctuation are correct			

#### 2.1.6.6 Draft report and the audit exit meeting

Once the audit report has been drafted it is good practice to issue it to management in draft form and use it to form the basis of discussions with management at the Audit Exit Meeting.

The purpose of an exit meeting with the auditee is to develop a mutual understanding of the content of the draft report. If possible the draft report should be sent in advance to those people who will be attending the meeting. This will give them a chance to read it and make the meeting much more useful.

The meeting should also help to avoid any misunderstandings or misinterpretations of fact by providing the opportunity for the auditee to clarify specific items and to express views on the issues raised in the report and the conclusions and recommendations. This should make it much easier to finalise the report and for management to complete the Action Plan.

Following the meeting the audit report should be amended and/or clarified where appropriate and necessary and a final version of the report should be issued together with the Action Plan for completion and return by management (see section 4 below for more guidance on Action Plans).

### 2.1.7 2.7 ACTION PLANS

Action plans are vital to recording and monitoring the action taken by management on Internal Audit's recommendations. They make follow-up audits easier and more effective. An Action Plan should be prepared for every standard audit report. It details what management have agreed to.

A template for an Action Plan is shown below. It lists every recommendation contained in the audit report and shows for each of them:

- The comments of management;
- Who is responsible for action, and
- The date by which action will be taken.

#### INTERNAL AUDIT DEPARTMENT

##### 2.1.7.1 ACTION PLAN - REPORT No:

<b>Rec No</b> (1)	<b>Recommendation</b> (2)	<b>Priority</b> (3)	<b>Comments of Management</b> (4)	<b>Action Agreed</b> Y/N (5)	<b>Person Responsible</b> (6)	<b>Implementation Date</b> (7)

##### 2.1.7.2 Completing the action plan

**Internal Audit is responsible for completing the sections headed 'Rec No' , 'Recommendation' and 'Priority' before the report is issued to the auditee.**

**Column (1) Recommendation number (RecNo)** - This is the number given to each recommendation in the Detailed Report (R1, R2, R3 etc). The Action Plan should include every recommendation made in the audit report and the recommendations should be listed in the order in which they appear in the Detailed Report.

**Column (2) Recommendation** - Each recommendation is included here, worded exactly as it

appears in the Detailed Report.

**Column (3) Priority** - This indicates the level of importance of the recommendation:

- **High:** A serious breakdown in control requiring immediate action by management;
- **Medium:** Weaknesses in control which need management action in the near future;
- **Low:** There is no significant risk arising from the weakness, but remedial action is recommended.

**The remaining sections are normally completed by the auditee, as follows:**

**Column (4) Comments of management** - This is to enable management to record their views on the recommendation. These could be simply to accept the recommendation; to accept it with minor amendments; or to propose an alternative solution to the problem. Unless the recommendation is accepted without change, the reasons for any changes or for rejecting it should be recorded here.

**Column (5) Action Agreed** – management should just indicate whether or not they agree to the suggested action with a simple 'yes' or 'no'

**Column (6) Person responsible** - This should record the name and title of the person who is to take responsibility for implementing the recommendation. Depending upon the nature of the recommendation, this could be either the person who will actually be making the changes, or the manager who is responsible for the unit, department, or sector to which the recommendation relates.

**Column (7) Implementation date** - The date by which management intend to make the recommended changes.

#### **2.1.7.3 Dealing with the completed action plan**

The Action Plan should be sent out with the final audit report and the Head of Internal Audit should ensure that it is completed and returned –together with any other management comments within ten working days. The completed Action Plan should be reviewed to ensure that:

- Recommendations have been accepted;
- Any alternative proposals by management are acceptable;
- An appropriate person has been made responsible for implementing each recommendation;
- Suitable dates for implementation are proposed.

When the report is issued to the Head of the Organisation, the completed Action Plan should be inserted after the Executive Summary and a copy of it placed on the Permanent Audit File.

Based on the timings set out in the action plan the Head of Internal Audit should schedule a follow-up audit – if necessary before the next planned audit.



### 3 3. FOLLOW-UP AUDITS

#### **2500 A1 – Monitoring Progress**

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

Too often this is the part of the audit process that is either done badly or not at all. In fact it is one of the most important stages of any audit. If internal audit fails to make sure that its recommendations are implemented, then all of the investment in doing the audit may be wasted.

The timing of the follow-up should be determined in relation to the significance and impact of the recommendations and the criticality of the system which has been audited. It should also take account of the implementation dates given in the Action Plan completed by management. It is important that time for follow-up audits is provided in the short term (annual) plan and that any specific follow-up audits are scheduled upon completion of each audit.

There are three main ways of following-up an audit, these are:

#### **By letter asking the auditee to confirm action has been taken**

In many cases, and certainly for those audits containing minor audit findings, this will be the most appropriate approach. Checks should then be made at the next scheduled audit to ensure appropriate action was actually taken and that the controls were implemented properly.

#### **Scheduling a specific follow-up audit**

This may involve either:

- An interim review of the systems and controls which have been introduced. This could include discussions with management to determine how they are operating and a limited programme of testing to ensure they are working as intended, or
- A full systems audit to establish that the correct action has been taken and controls are working effectively. Where no action has been taken by management the audit should establish and quantify the impact of the failure to establish adequate control.

In deciding whether to do an interim review or a full systems audit some things to consider are:

- The risk, importance and materiality of the system;
- Known changes in organisational objectives or priorities since the audit was done;
- The stability of the system (systems which are subject to frequent change are less likely to be suitable for interim reviews and may have to be subject to a full audit more frequently);
- The extent of the changes recommended in the audit report;
- Any indication that significant changes or new systems developments may have taken place.

**Follow-up as part of the next audit**

It should be standard practice on any scheduled audit to carry out a follow up to establish the extent of implementation of the recommendations made at the last audit. This should be done at the start of the audit so that audit testing can be adjusted appropriately. The audit report should highlight clearly any further action which needs to be taken in relation to the last audit.

### 3.1.1 AUDIT FILES

#### 2330 Documenting Information

Internal auditors must document relevant information to support the conclusions and engagement results.

The working papers and any other documentation related to each audit assignment should be held on dedicated audit files. Those files should be structured in a clear and logical way in order to make it easy for anyone to find what they need and to understand what has been done, and why. The files can be held in electronic or paper form.

Appropriate use of indexes and of cross-referencing between documents and sections of the files is vital if documentation is to be accessible and assist the auditor to carry out the audit efficiently. This will also help anyone using or reviewing the files to follow the steps taken during the audit and to understand how conclusions were reached.

Maintaining well organized and structured audit files:

- Enables the audit to be conducted in a logical manner;
- Helps ensure comprehensive coverage;
- Aids understanding;
- Makes it easier to identify weaknesses and draw the correct conclusions;
- Enables progress and findings to be readily reviewed;
- Makes report drafting easier;
- Facilitates the location of papers; and
- Provides a formal record of the work undertaken.

Two types of file should be maintained for each audit - the Permanent File and the Current File.

*The Permanent Audit File* - contains all the ongoing information about the system, unit or department under review. It provides essential background knowledge to the person undertaking the audit and should be reviewed at the start of each new audit of that system etc. It should also be updated at the end of the audit.

*The Current Audit File* - which documents all the information collected during the current audit. It contains a detailed history of the current audit from the start when you determine the scope and objectives through to the completed Implementation Plan. It is advisable to create this file at the start of the audit and, as far as possible, to build it up during the course of the audit.

A suggested structure for each of these files is given below.

### 3.1.1.1 Permanent Audit File

SECTION	TITLE	CONTENT
<b>A</b>	General background information	<p>To include:</p> <ul style="list-style-type: none"> <li>• Terms of reference for the audit</li> <li>• Operational and/or financial objectives for the system/area under review</li> <li>• Organisation charts for the unit/area under review</li> <li>• Budgets and expenditures for the area being audited</li> <li>• Volume of transactions – or other appropriate measure of the scale of the system</li> <li>• Other background information and relevant documents (copies or references, as appropriate)</li> <li>•</li> </ul>
<b>B</b>	Reports to management	<p>Copies of all internal audit reports (draft and final versions)</p> <p>Action Plans</p> <p>(All correspondence and other documentation should be kept in the relevant current audit files)</p>
<b>C</b>	Copies of other relevant reports	<p>Reports of SAI (extract relating to the system under review)</p> <p>Consultancy Reports for the area under review</p>
<b>D</b>	Draft of policies and procedures in operation	<p>Rulebooks, Detailed procedures and Guidance issued in relation to the area under review</p>
<b>E</b>	Relevant job descriptions and authority limits	<ul style="list-style-type: none"> <li>• Rulebook on organizational structure with organizational chart and list of employees – related to area under review</li> <li>• Job descriptions and other relevant documents</li> </ul>
<b>F</b>	Sample documentation	<p>Blank copies of any relevant forms used in the system under review</p>

### 3.1.1.2 Current Audit File

SECTION	TITLE	CONTENT
1*	Audit supervision and review papers	The completed Audit Review Record and any detailed notes and comments by Head of Internal Audit
2	Audit planning documents	Audit Plan Terms of reference Notes on initial discussions etc with the Ministry/organization Projected and actual time budgets
3	Previous audit report	Copy of the previous Internal audit report, including relevant correspondence and action plan
4	Points forward	List of points highlighted for future work by internal audit
5	Current audit report	Draft Internal Audit Report with Action plan Final Internal Audit Report All relevant correspondence Minutes of exit and final meetings
6	Follow -up to last audit	Details of tests done to check implementation of recommendations made Summary of current state of implementation
7	Systems and Procedures in operation	To include flowcharts, narrative descriptions and sample documentation, as appropriate
8	Control Objectives	To list control objectives per each identified system
9	Audit Findings Form	Evaluation of weaknesses, causes and effects
10, 11, 12, etc.	Working papers- divided into sections(e.g. by sub-system) as appropriate	To include: Control& Risk Evaluation forms TEST PROGRAMMEs and other details of tests carried out Notes of meetings with staff and managers

### **3.1.2 3.1 SUPERVISING INDIVIDUAL AUDITS**

#### **2340 Supervising Audit Assignments**

Audits must be properly supervised to ensure objectives are achieved, quality is assured and staff developed.

This section of the Audit Manual should be developed when Internal Audit is fully established and there is sufficient capacity to carry out effective supervision activities.

In the meantime, the Head of Internal Audit should review the work of audit staff at each stage of an audit. CHU should conduct regular reviews of the work of IA units in order to ensure that audits are carried out in accordance with the guidance in this audit manual.

### 4.1.1 COMMUNICATION SKILLS AND TECHNIQUES

#### 4.1.1.1 *The opening meeting with management*

##### **Purpose of the meeting**

The opening meeting with management is very important. It sets the tone for the entire audit and provides the opportunity to establish the proper atmosphere and to begin building effective working relationships.

At the opening meeting you should:

- Explain the role of internal audit (only if it is the first time an audit has been done in the organisation), and to emphasise that the main objective is to provide constructive help and advice;
- Discuss and agree the scope and objectives of the audit – making it clear that you welcome any questions and also the views and suggestions of management;
- Ask for the views of management on any problems which may exist in the activities which fall within the scope of the audit. This helps to demonstrate that you welcome their input and that you are not just looking to be critical of what they are doing;
- Discuss the timing of the audit – and any difficulties which could arise from it (eg the absence of key personnel, new systems development etc). You need to beware of the danger of management raising timing difficulties as a way of having the audit postponed;
- Establish who you need to see at the beginning of the audit. It is also important to agree with management that you can make direct contact with staff, rather than clearing all meetings etc with the line manager;
- Set out the procedures that will be adopted for:
  - Confirming audit findings;
  - Discussing the draft report;
  - Issuing the final report.
- Explain that everything will be treated in confidence;
- Establish the normal working hours of staff in the department, where they are located (particularly if some work is done outside of the organisation's offices) and any other office routines – to make it easier to arrange meetings, locate people etc.;
- Make it clear that you will need access to all relevant files and documents;
- Ask for the use of an office/desk during the course of the audit – if necessary.

A well-conducted opening meeting can ensure that the audit is conducted in a friendly and positive atmosphere. It can make the difference between active cooperation and open hostility.

A record of the opening meeting should be made and filed on the current audit file.



#### **4.1.1.2 The exit meeting**

##### **Purpose**

The purpose of an exit meeting with the auditee is to develop a mutual understanding of the content of the draft report and of any other audit concerns that are not set out in the report. If possible the draft report should be sent in advance to those people who will be attending the meeting. This will give them a chance to read it and make the meeting much more useful.

It is intended to avoid any misunderstandings or misinterpretations of fact by providing the opportunity for the auditee to clarify specific items and to express views on the significant audit concerns, recommendations and other information presented in the draft report. In this way the formal response from the auditee should not contain any surprises for the auditor. Additionally, the exit meeting should serve as an opportunity to develop a feeling that the report is offered in a spirit of working together to improve the way things are being done.

##### **Timing**

The Head of Internal Audit should contact management to determine a suitable time and location for the exit meeting. This should normally be immediately after completion of the fieldwork.

##### **Attendees**

Attendees should include anyone who may be able to object to the validity of the report's contents and anyone having responsibility for the area or the situation needing corrective action - whether or not they personally would take the action or would be affected by the action.

##### **Discussion**

The exit meeting can be either a difficult confrontation or an open and courteous discussion. The discussion topics at each exit meeting will vary depending upon the specific audit concerns identified and who is attending the meeting. At a minimum, the auditor should:

- Summarize the audit including what was done (objectives, scope, procedures);
- State why it was done – the thought process behind your decisions;
- Outline the risks identified;
- Outline the significant audit concerns and the recommendations for dealing with the associated risk;
- Indicate the significant audit concerns which have already been corrected, and
- Refer to any less significant concerns identified in the audit.

The auditor should be willing and able to discuss all matters in whatever detail is necessary. It is also important to make it clear that all significant audit concerns have been discussed with management and that the report contains no surprises. You may also want to thank them for the cooperation obtained during the audit - if that is appropriate.

### ***Avoiding Confrontation***

The auditor should be prepared for the possibility of conflict when presenting the concerns in the audit report and should be able to retrieve information, support facts and amplify findings without difficulty or delay. To encourage the avoidance of confrontation during the exit meeting, the auditor should:

- Be polite throughout the meeting;
- Avoid the use of non-personal phrases (e.g., try not to start a sentence with "you" when disagreeing);
- Make efforts to get on common ground;
- Avoid backing the auditee into a corner.

### ***Addressing Confrontation***

First, it is important not to mistake the airing of views with disagreement. Often all that is necessary is to let the auditees express their views. Perhaps they do not really disagree but merely want a chance to justify their position or to explain the reasons for the conditions the auditor found. After they have made their point, they may be perfectly willing to let the wording of the draft stand as written. In some situations, offering to quote the auditee may end the disagreement.

Auditors must react and adjust their approach according to the discussions and facts presented. The auditor must maintain a state of fairness and objectivity, and be concerned only with what is factual and significant. This means that the auditor should be open to changes that make for a more understandable and more accurate report and do not compromise the audit findings, conclusions, and recommendations.

### ***Draft Revisions***

The auditor should be willing to accept wording changes or other suggested revisions that they believe are appropriate - as long as the changes do not alter the audit opinion or change the focus of any significant audit concern or corrective action. When there is an irreconcilable disagreement and there is no misinterpretation of fact (the facts must be agreed upon), the auditor may then point out that they must report matters as they see them and that they are willing to incorporate the auditee's views, or response, as well.

### ***Ending the meeting***

At the end of the meeting it is useful to summarise the points arising from the meeting and to confirm what the next steps will be and the anticipated timing of the issue of the final report.

#### **4.1.1.3 Interview techniques & effective communication**

##### **Introduction**

Interviews are a key part of the audit process. They are an important way of obtaining and confirming information and facts about the way systems and controls are being operated. At the same time they represent an opportunity to create and maintain good relations between the audit department and its clients, and to impress the client with the professionalism of internal audit.

There are two types of interview – directive and non-directive. The directive interview is intended to obtain specific information about verifiable facts – for example the procedure for paying purchase invoices. In this type of meeting the auditor plans the meeting to establish what information is needed and determines questions which will provide that information. The auditor controls the meeting throughout, setting the tone and pace, and keeping the discussion in line with the planned objectives. The advantage of directive interviews is that they give the auditor exactly what he/she wants to know. The disadvantage is that they discover very little else.

In contrast the non-directive interview is intended to achieve understanding and build confidence with the auditee. Direct questions are avoided and the interview is structured only to the extent that the auditor identifies and opens up broad areas of discussion. This approach has the potential to uncover new areas for audit, but non-directive interviews have to be well controlled or they can be very long and time-consuming.

There is no ‘best’ method of interviewing. The approach depends on the person being interviewed, the nature of the audit, the type of information needed and the time available. In many cases interviews are a combination of the two approaches, starting with a directive approach to get the information needed and ending with a non-directive approach to allow the interviewee to broaden out the discussion.

Whichever approach you take there are a number of things you need to do to maximise the benefit gained from your interviews. The main steps are set out in the following sections.

##### **Planning the interview**

If you have a good relationship with the interviewee, or have already met him/her several times, then it may be possible to call in casually and unexpectedly. If not then it is normally best to plan the interview and to make a proper appointment in advance.

In planning for the interview you should:

- Decide what the purpose of the meeting is;
- Decide what information you want from the interviewee;
- Give adequate notice of the interview – wherever possible. Try to take account of peak workloads in the department when scheduling the interview;
- Always carry out the interview in the interviewee’s office (unless he/she insists otherwise). It is important that the setting for the interview should put the interviewee at ease and preferably be free from interruptions. It should also allow the auditee to talk without being overheard;
- Tell the interviewee what the purpose of the meeting is;
- Give advance notice of any specific information you need;
- Prepare any files or documents you need to take with you;
- Write down the questions you want to ask.

When you are arranging interviews try not to schedule them one after the other. Allow some time in between so that you can review your notes while the points are still fresh in your mind.

### **Opening the interview**

Resist the temptation to rush straight into the interview. Instead start by making an effort to put the interviewee at ease and establish rapport with him/her. Devote time to some general conversation in order to get the interviewee talking easily. For example, if it's the first time you have met it may be useful to comment on the interviewee's office (it could be particularly large or have a nice view of the city) or the office building in general (for example, if it is a new building, or one the auditee has just move into). Whatever you say make sure that it is sincere. The first few minutes of the meeting are often particularly important when the interviewee appears apprehensive, or is a junior member of staff.

If, however, the auditee appears pressed for time, small talk may be unwelcome and irritating to them. Open the interview according to the mood of the auditee - but always try to be informal, friendly, and natural.

It is a matter of judgement when it is the right time to start the interview proper. The main thing is to do this when the interviewee is relaxed enough and in the right mood. This switch needs to be done tactfully – e.g. you could say: "I'm concerned that I may be taking up too much of your time, perhaps I could ask you ....."

Before starting the main part of the interview it is useful to check how much time the interviewee has available. This allows you to adjust your approach, speed and focus if necessary.

### **The interview**

It is important not to conduct the interview like an interrogation. Keep in mind at all times that the auditee should do most of the talking and that you need to listen carefully.

During the interview it is worth remembering:

- That you should not talk down to the interviewee no matter how junior the person is;
- To maintain a helpful, pleasant and interested manner – even if the interviewee is unpleasant and uncooperative;
- To look at the interviewee when he/she is talking and when you are asking questions. Avoid staring, which can cause embarrassment or tension, by looking away briefly from time to time;
- To smile, nod your head in agreement etc whilst the interviewee is talking to show attention, interest and agreement;
- To avoid doing anything that may indicate you disagree with, disapprove of or don't believe anything said;
- Not to comment unfavourably or challenge anything said. However, you should ask for clarification and explanation where necessary;
- Not to get involved in an argument;
- To be alert for reactions which may indicate that he/she is unsure of or doesn't understand what has been said;
- To think carefully about the answers you are given. First, to decide what is fact and what is opinion, and second to decide the future direction of your questioning.

## **Keeping the discussion on the right track**

You need to be prepared to accept that a certain amount of time will be wasted in any interview – mainly because interviewees will not keep to the point. Some are more likely to wander off the point than others. It is essential that you try not to introduce any digressions into the interview or encourage the interviewee to make any digressions.

When you need to get the interviewee back onto the point it is important to try to do so tactfully. Controlling such digressions can be a major problem. If you do it too obviously you run the risk of upsetting the interviewee and losing their cooperation. If you don't control them you will waste time and probably not get all the information you need. Try at all times to show a keen interest in what is being said and avoid all signs of frustration or impatience.

## **Closing the interview**

Once you have achieved everything you want of the interview, then you need to take the initiative in bringing it to an end. However, if the interviewee is obviously willing to talk and is giving you useful information do not stop just because you have taken up the scheduled time – useful information can sometimes be lost that way.

In closing the interview follow the normal rules of courtesy and common sense. This means you should always:

- Thank the interviewee for their time and their help;
- Ask them to call or email you if, after the meeting, they think of anything else which is important or relevant;
- Confirm any action points agreed during the interview – e.g. agreement to provide documents, further information etc.;
- Leave yourself the opportunity to go back for further information or clarification by saying something like: "It's possible that I may need to clarify something when I go through my notes. If so would you mind if I called you or came to see you again for a few minutes?"

## **After the interview**

Try to read through your notes as soon as possible after the interview. Make any amendments to the notes and identify any additional information or clarification needed.

If you have agreed to do something or to provide something to the interviewee make sure you do this as soon as possible. If you don't do so it will damage your credibility and your relationship with the interviewee.

## **Things to remember about effective communication**

### ***Verbal communication***

You will only get the information you need if both you and the interviewee attach the same meaning to the questions you ask and to the answers he/she gives. It is very easy to interpret words and phrases in a different way from that intended by the speaker. In order to reduce the risk of misunderstandings it may be helpful:

- To think carefully about each question you ask, and try to phrase them in a clear and unambiguous way;
- To keep each question as short as possible – and don't ask several questions all at once;

- To use short, simple, familiar words to maximise the chance that the interviewee will interpret them correctly;
- To avoid the use of jargon and technical terms that the interviewee may not understand;
- To avoid the use of vague, general or imprecise words (such as quickly or often) or abstract words (such as successful) which can be interpreted in a number of different ways;
- To avoid asking questions, which could produce an emotional reaction from the interviewee (e.g. "What do you think is causing the poor performance of your sector or unit?").

### ***Non-verbal communication***

Non-verbal communication is an important part of the communication process, and interviewers often forget to watch for and respond to non-verbal messages which are given out by the interviewee.

Examples of things to look out for are:

- The head nodding to signify understanding and acceptance;
- The frown that signifies lack of understanding or confusion;
- The set expression of the face or mouth that indicates disagreement;
- The flickering of the eyes that signifies uncertainty about how to answer – or unwillingness to answer.

Don't forget that you too send out non-verbal messages, and you can make use of them to help the interview to run smoothly and effectively. For example, you can use facial expressions, your eyes, movements of the head and body, smiles and hand gestures to show enthusiasm for the audit and agreement with the points being made by the interviewee. Non-verbal messages can help to make what you are saying more acceptable to the interviewee (e.g. if you ask a question in a rather forceful way which could cause offence, a smile at the end of the question can help to make it more acceptable). You can also try to encourage and compliment the interviewee – for example, nodding your head slowly whilst the interviewee is talking shows that you are both listening to and understanding what is being said.

The most important thing to remember is to make sure that your facial expressions, eyes, body movements, and gestures cannot be interpreted as indicating a lack of interest in, disagreement with or disapproval of what the interviewee is saying. Also, smiling is an effective way of creating a pleasant, friendly atmosphere and of encouraging the interviewee.

### ***Asking questions the right way***

First, remember not to talk too much, this is one of the biggest mistakes made by auditors when they are interviewing.

There are two kinds of questions, the '**open**' question, and the '**closed**' question.

**Open** questions usually force the interviewee to think about the answer, and give the freedom to reply in the way he/she thinks best. They can produce a wide variety of possible answers. Open questions often begin with words like: "Why", "How", "What" and "Which". For example: "Why is it necessary to check the document at this stage?", "How does the information in this report help you?", "What changes would you like to see to the way this procedure operates?"

**Closed** questions allow the interviewee much less choice in his/her reply, often resulting in a "Yes" or "No" answer. For example: "Do you review this document/report?", "Are the current procedures working well?", "So you prepare this document yourself then?" Closed questions have a tendency to produce an answer the interviewee thinks the auditor wants to hear and not the true situation.

They allow little room for discussion and make it difficult for the interviewee to develop his/her own ideas. However, they are useful to get specific items of information or to confirm basic facts and figures.

When asking questions it is useful to remember:

- To be as friendly and pleasant as possible, and to smile;
- To watch the interviewee's facial expressions to check whether they understand or are confused;
- Not to rush the interviewee to give an answer – keep quiet and glance away if necessary;
- If the interviewee is unable to answer the question after a reasonable time, suggest you move on to the next point and come back to it later.

When it comes to the questions themselves:

- Try to think them out in advance as part of the planning for the meeting – but be prepared to be flexible in the light of the answers you are given;
- Keep each question clear and concise and limit it to a single point or issue;
- Use words and language which the interviewee will understand and can relate to;
- Don't ask too many questions which cover any aspect too broadly;
- Try to ask your questions in a logical order, but be prepared to follow up points of interest as they arise.

### ***The importance of listening***

Most people find listening very hard. It is very difficult to listen attentively for more than about 30 minutes, after that our concentration drops. There are many reasons why people don't listen well, including:

- Getting distracted by something the interviewee says or does, or the way he/she appears. This could include annoying mannerisms or ways of speaking, their physical appearance or the way they dress;
- The temperature of the room, an uncomfortable chair etc;
- Failing to listen because you are tired or have other things on your mind;
- Failing to look at the interviewee and losing the benefit of any non-verbal communication.

To improve your listening skills you should:

- Look at the interviewee when he/she is talking;
- Sit up – to increase your mental alertness;
- Pay full attention and concentrate on trying to understand what is being said;
- Try not to let yourself get diverted.

Most importantly, don't talk too much. Too often internal auditors waste valuable time by interrupting the interviewee and expressing their own views and opinions at great length. Remember, your main role in these meetings is to get the interviewee to talk.

## ***Taking notes***

There are many ways of taking notes and you need to develop an approach which works for you. Some things to consider are:

- Asking the interviewer at the start whether they mind if you take notes;
- Don't make your note-taking too obvious, as it can put the interviewee off;
- Keep note-taking to the minimum, but making sure you record the key points;
- Don't look at your notepad except when you are writing;
- Try to keep your notes intelligible and legible so that you can make sense of them after the meeting;
- Review your notes as soon after the meeting as possible, and clarify and amplify them wherever necessary.



### 5.1.1 TYPES OF CONTROL

There are four basic types of control:

- *Preventive* - designed to prevent the occurrence of inefficiencies, errors, or irregularities. These cannot guarantee that the controlled factor will not occur but reduce the chance of it occurring. Examples include division of duties and setting authorization levels;
- *Detective* - designed to detect and correct inefficiencies, errors, or irregularities. They may not give absolute assurance since they operate after an event has occurred or an output has been produced, but they should reduce the risk of undesirable consequences as they enable remedial action to be taken. Detective controls are most effective when they form part of a feedback loop in which their results are monitored and used to improve procedures or preventive controls. Examples include post-payment checks, stock verification and bank reconciliations;
- *Directive* - designed to cause or encourage events necessary to the achievement of objectives. Examples include clear definition of policies and procedures, the setting of targets, and adequate training and staffing;
- *Corrective* - to identify and evaluate alternative courses of action, to implement appropriate measures to remedy the situation and minimize damage.

In practice the above categories may not be clearly distinguished and a single control may operate to cover two or more functions. Supervision, for example, covers three categories.

#### Some examples of internal controls

These examples start with the higher level controls, followed by intermediate and then low level controls. They are relevant to both manual and computer-based systems.

#### High level controls

##### *Planning*

This involves establishing aims, objectives and targets and the means by which they are to be achieved. Good planning includes:

- Clear definitions of objectives and targets;
- Forecasting of activity, operational requirements and external factors which may affect the achievement of objectives;
- Specifying desired levels of control taking account of risk;
- Setting standards of performance;
- Defining, wherever possible, the outputs of a system and criteria for measuring them;
- Evaluating different options for achieving objectives;
- Anticipating contingencies, and devising suitable action to take in response;
- Indications of the relative priorities of objectives, targets and their related activities;
- Budgetary constraints.

## ***Written guidance***

Management's policies and operational procedures should be documented to ensure that all staff are aware of them and work together to achieve objectives. Written guidance and procedures manuals should be:

- Clear, unambiguous and easy to refer to;
- Accessible to all relevant staff;
- Subject to checks by management to ensure that they are read and understood;
- Reviewed regularly, and any changes brought to the attention of staff and implemented promptly.

## ***Organizational controls***

These involve allocating responsibility to individuals or groups so that they work together to achieve objectives in the most efficient manner. Accountability and authority should be allocated to match responsibility. Major principles of good organization include:

- Providing clear and documented definition of the responsibilities of individuals and groups for resources, activities, objectives and targets;
- Establishing clear reporting lines;
- Finding the most efficient balance of duties between different organizational groups;
- Establishing the most effective spans of command without creating more levels in the management chain than necessary;
- Establishing effective means of communication throughout the organization;
- Separating duties to avoid conflicts of interest or opportunities for abuse;
- Avoiding undue reliance on any one individual, particularly for internal control.

## ***Intermediate level controls***

### ***Monitoring performance***

Management needs to monitor performance to ensure that operations are conducted to achieve the optimum economy, efficiency, and effectiveness. Quality control should be built in to systems.

Management should establish its needs for, and use of, information about activities. Relevant information may be in the form of statistics, accounts, analyses, or reports. It may be produced on a regular schedule, at management's discretion, or only when predetermined exceptional conditions are met. Management information should be reviewed regularly to ensure that it is relevant to needs and is being effectively used.

Management information should include measures and indicators of performance in respect of efficiency, effectiveness, economy, and quality of service. This involves identification of inputs, including costs, and outputs and relating them to objectives.

The results of monitoring provide the basis for future action and should be linked to procedures for correcting or adjusting activities accordingly.

### ***Evaluation***

Policies and activities should be evaluated periodically for economy, efficiency, and effectiveness. They should:

- Be planned from the beginning of the operation;

- Have well-defined objectives and scope;
- Establish yardsticks or standards with which to make comparisons;
- Consider measures and indicators of performance;
- Identify outcomes;
- Identify follow-up action and provide the input for reappraisal of future options.

### *Staffing*

Adequate staffing of management functions and operations is essential for a system to function to its full capability. Weaknesses in staffing can lead to mismanagement, error and abuse which can negate the effect of other controls. The major aspects of staffing which have control implications are:

- Identifying and reviewing the staffing needs: numbers, grades, experience and expertise levels;
- Recruiting and selecting staff to meet the needs;
- Monitoring performance of individuals and groups;
- Arranging training and other staff development measures to achieve the full potential of staff capability.

### *Supervision*

Supervision is the function by which managers scrutinise the work and performance of their staff. It provides a check that staff are performing to meet standards and in accordance with instructions. It includes checks over the operation of controls by staff at lower levels. Good supervision can raise motivation, enhance quality, and assist with staff development. Poor or heavy-handed supervision can lead to de-motivated staff, who have little freedom for innovation and flexibility of response and fail to meet required standards.

### *Budgetary and other financial controls*

Budgetary control matches resources and costs to responsibilities for objectives and outputs. Managers become fully accountable for the achievement of their objectives and targets. It should be applied wherever possible and incorporated within an overall budgetary control system. It can be applied easily to most administrative functions, but may prove difficult in areas where costs or outputs cannot easily be quantified or where responsibilities are unclear.

Budgets should be realistic to allow for essential expenditure to achieve objectives, but should be sufficiently tight to encourage the economic and efficient use of resources. They also should be closely linked to planning and review procedures to ensure that any proposed expenditure is essential.

### *Accounting controls*

Organisations must keep adequate financial and other information to allow the accounts to be produced in the form prescribed. Internal auditors should understand the financial reporting requirements and the relevance of accounting standards and recommended practices. There should be adequate controls to ensure that requirements of regularity and propriety of expenditure are met.

### *Systems development*

Controls over the development of new systems and modifications to existing systems or procedures are essential to ensure that:

- New or revised systems meet their objectives;
- The effect of changes on systems and controls is properly assessed at an early stage before implementation;
- Systems modifications are approved and authorized;
- Adequate plans are made for a change from one system to another;
- The implementation and application of new or revised systems and procedures are in accordance with plans.

## **Low level controls**

### *Authorization*

This is the approval or sanction of specified activities or transactions by a manager or other responsible person before they are undertaken. It ensures that proper responsibility is taken for the controlled activities. Key features are:

- Defining the authorization requirements for activities and transactions;
- Allocating authority to appropriate individuals or groups;
- Separating responsibility for authorization from involvement in other activities which could lead to a conflict of interest;
- Checking that relevant activities and transactions have been properly authorized.

### *Documentation*

This involves recording information and transactions used in an organisation's business. Good standards of documentation should be established to assist and support activities and to help ensure the continuity of operations in the event of disruption. This includes the retention of information in electronic or other forms. Information must be accessible and good filing and search facilities are essential.

The work of the organization should be sufficiently well documented to enable management, external auditors, or other reviewers to follow the course of operations and transactions and to identify errors, abuse, or poor performance. Decisions, authorizations, transactions, checks, and other information should be clearly recorded and the records safeguarded.

Standard documentation and forms can help to enforce conformity with procedures and legal requirements. They are often used to control transactions or the movement of valuables. Such documentation should be carefully designed to meet its objectives.

### *Completeness and accuracy*

- Transactions should be recorded as close to their origin as possible;
- Transactions should be checked at appropriate times in the processing cycle;
- Checks should be carried out by staff independent of those performing the activities checked.

Typical controls to ensure completeness and accuracy include sequence checking, comparison with related documents, control totals, arithmetic checks, and re-performance.

### *Physical controls*

These are concerned with the custody and safety of assets and information. They cover the whole physical environment in which systems operate. The major categories are:

- Access controls such as guards, identity cards, passwords, computer logging;
- Physical checks on assets and records such as stock takes, security inspections;
- Environmental controls such as thermostats, health and safety inspections;

The geographical location or situation within a building of activities, and the secure custody of assets and records.