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ENTERPRISE INTERNAL AUDIT AND CONTROL

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„Development and Approbation of Applied Courses Based on the Transfer of Teaching Innovations in Finance and Management for Further Education of Entrepreneurs and Specialists in Latvia, Lithuania and Bulgaria"

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ENTERPRISE INTERNAL AUDIT AND CONTROL

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C O N T E N T S

INTRODUCTION

This study aid is designed for learning basic knowledge on internal audit and internal control and is intended for enterprise managers and other executive staff members exercising flexible management policy and searching for new opportunities of achieving the goals set. It can be also used by students of economics and business administration programmes in higher educational establishments and by other individuals concerned.

The syllabus of this course has been developed within the framework of the *Leonardo Da Vinci* project 'Development and Approbation of Applied Courses Based on the Transfer of Teaching Innovations in Finance and Management for Further Education of Entrepreneurs and Specialists in Latvia, Lithuania and Bulgaria' in the year 2009-2010. Its main objective is to provide the opportunity for working enterprise specialists to obtain the knowledge necessary for their practice by using innovative training methods. For this purpose the study materials have been placed in the *Moodle* environment as an e-course enabling the studies not only in auditoriums and libraries, but wherever there is an internet access and anytime whenever there is time for studying.

The study materials offered for learning of the course syllabus have been arranged in seven chapters. The first two chapters introduce to the concept, regulation and areas of application as well as with the main basis of internal audit. Chapter three provides with a detailed outline of the methods applied and the stages involved in performing internal audits. The students have the possibility not only to learn the theory but also to boost their knowledge in practical case analysis and simulation of the audit process. Chapter four is devoted to the International Standards for the Professional Practice of Internal Auditing, while chapter five gives the possibility to get introduced to the operation or performance audit and the links and differences between the risk-based audit and the systems audit. Chapters six and seven are allocated for the object of concern in internal auditing – the internal control system the building of which is entirely under the responsibility of the enterprise manager. Apart from the rules of the general internal control systems the study materials also include the description of the control procedures and rules of two business cycles – purchasing and sales. Self-control of the knowledge obtained can be performed by answering the control questions included at the end of each chapter.

Subject 1

Preconditions for development of internal auditing and definitions, internal and external audit comparison

1.1. The need for internal auditing

1.2. Historical aspects for development of internal auditing

1.3. Internal audit definitions

1.4. Regulation framework of internal auditing at the international level and in the Latvian regulatory acts

1.5. Internal and external audit comparison

1.6. Internal audit development stages

1.1. The need for internal auditing

Industrial revolution served as the precondition for the development of IA with the segregation of assets from management and the emerging of public limited liability companies. This was an important condition for the establishment of regulatory bodies in order to ensure appropriate asset management based on the data from the accounting systems, control systems and audits required by the legislation governing business and other statutes.

In contemporary circumstances as the competition between enterprises intensifies the need for an efficient use of all kinds of resources required for business activities, and therefore also the need to enhance control over such use, increases. An ordinarily functioning control enhances the capacity of better serving the customer needs while making it consistent with an effective use of capital and resources as well as ensuring a constant increase in revenues for a certain period of time despite the expansion of the enterprise capacity. In conditions of competition control should also create certain advantages in relation to other enterprises. This means that the previous forms of business control as an integral part of management must be improved in order to perform all of tasks that are current under the present conditions.

What forms of business control are common in Latvia?

- ***State audit*** – audit of operations in enterprises and institutions financed by the state and local governments;

- ***Tax audits*** – audit of procedures for tax estimation and payment;
- ***Certified auditors service*** – auditing of annual reports of business enterprises and local governments;
- ***Internal audit*** or ***internal auditing services*** – present in business enterprises and in the public administration system.

While the two first are implemented in the interests of the government, this is only partially true regarding the other two types of control. On the one hand, the services of certified auditors are not required for all of the enterprises, but are required for all local governments, while internal review or internal auditing is required for state government departments, for different project implementation processes, but is not statutory for business enterprises.

Within the scope of this course syllabus we will try to clarify and learn the benefits of and the need for internal auditing in areas where there are no statutory requirements for its use, consequently, in business enterprises.

There is a certain legislative regulation in place for the state departments, their subordinated authorities and international projects serving as the basis for the establishment and realisation of internal auditing. However, there is no such regulation established in respect of the business units and therefore it must be clarified what is the substantiation for the use of internal audits in the management process of enterprises and business companies.

On the one hand, the LR CM Regulations No 585 'On the Conduct and Organisation of Accounting' lay down the requirement to establish accounting control which is a part of internal control, while, on the other hand, the enterprise management is responsible for sufficient accounting control. Consequently the management must by any means perform regular assessment of this control system, including accounting control.

The management may use the following techniques in the area of internal accounting in order to maintain an up-to-date internal control system:

a) direct management control;

b) own assessment of internal controls;

c) internal audit.

One of the conditions defining the necessity for internal auditing is therefore **<u>the need for a flexible updating of the internal control system.</u>** It is entirely clear that the various control procedures within the internal control system that are implemented at the management initiative are introduced for the elimination of significant enterprise risks, while these risks usually occur as a result of changes in the control environment. The fact that as the enterprises do their business the risks are not identified and assessed at all is a reality often leading enterprises into significant losses and sometimes even to enterprise bankruptcy and dissolution. In the course of several decades the best practice in the world accumulated in the activities of business units proves that IA can provide an enormous input in the process of resolving these problems.

1.2. Historical aspects for development of internal auditing

The beginnings of IA can be found already in the 19th century although the news about internal auditors in the public sector, who were enterprise employees, but were independent of the enterprise managers, refer to the early 20th century Great Britain. Qualitatively new development started for IA after World War II. In New York, in 1941, the Institute of Internal Auditors was founded, in 1944 – a member of the Institute in Toronto, Canada, while in 1948 – the first member outside North America – in London.

Along with other activities IA grew as an enterprise management function. Its definition has been changed 5 times in the course of fifty years. For many years the emphasis was laid on the independent appraisal function aimed at examining the accounting, financial and other transactions.

In the beginning of 70-ties of the previous century the meaning of audit became more extensive as it included not only financial audits, but also the independent appraisal function which includes examination of the operations carried out and constitutes a service to the management.

In the beginning of the 80-ties the meaning of IA was extended once again to cover the enterprise internal control systems and the examination and evaluation of the performance adequacy and effectiveness of the assigned responsibilities.

In 1999 IIA (Institute of Internal Auditors) changed the definition of internal auditing again by emphasising its role in the achievement of the enterprise goals.

Since 21st August 1991 when the Supreme Council of the LR adopted the law 'On the Statehood of the Republic of Latvia' the National Control and other control institutions operating pursuant to the laws of the USSR ceased to exist. Until 28th October 1993, when the law 'On State Control' and 'On State Revenue Service' was adopted, the national economy was left practically without appropriate control.

The need for introducing the IA in our state administration was determined both by the requirements set forth by the EU for increasing of administrative capacity and the internal requirement for IA in the Latvian State Administration. More and more often when monitoring the performance of state administrative bodies their managers found that there is a necessity for a system that would allow identify early whether the achievement of the set goals is done efficiently. Within the framework of a contemporary state constitutional system the function of auditing is considered to be one of the key elements ensuring a democratic and efficient performance of state administration.

The process of introducing the IA in the Latvian State Administration started in May of 1997 when the State Civil Service Authority in cooperation with the British Council held seminars for the state department representatives and discussions with the state department secretaries. This is considered the commencement of IA in our country.

Apart from the establishment of an IA system in the state administrative institutions there is also an IIA member body founded in Latvia.

The Institute of Internal Auditors (IIA) is an international association dealing with the raising of internal auditing performance quality and qualification of internal auditors. IIA has been founded in 1941 in the USA and currently comprises more than 85,000 members from about 120 countries operating in the area of internal audit, management and internal control, IT audit, education, security and other internal audit related areas.

IIA is one of the leading organisations carrying out training and certification of internal auditors as well as performing different research works, providing recommendations for those areas of activity related to internal auditing.

The main objectives of IIA are as follows:

- providing comprehensive professional development by designing appropriate training programs, organising courses and performing certification of internal auditors;
- researching and disseminating the knowledge concerning internal auditing, internal control and its related areas by promoting the knowledge not only to the IIA members, but also to the wider public across the world;
- establishing of IIA member bodies world wide that would conduct the education of internal auditors in line with the specifics relevant for each country;

- bringing together internal auditors across the world to share information and experiences, and thus gaining new knowledge.

The Latvian member body of IIA has been founded in 1999 in Riga and currently embraces above 100 of its own members. The main purpose of the Latvian member body of the IIA is to bring together the internal auditing practitioners within Latvia, provide with further educational opportunities and ensure appropriate information sharing among the professionals in this area. IIA is closely collaborating with different professional bodies across the world, for example, the American Accounting Association, the Institute of Management Accountants, the Financial Management Institute, Accounting Education Advisory Committee and others.

The Latvian member body of IIA has a long-established cooperation with the Latvian Association of Certified Auditors, PriceWaterhouseCoopers SIA, BA School of Business and Finance and other organisations.

It means that sufficient grounds has been established in Latvia for a better understanding of the advantages given by IA so that they can be applied also in business enterprises.

1.3. Definitions of internal auditing

In the past internal audit in many organisations dealt solely with the finances, accounting, reconciliation, protection of assets and accuracy. Unfortunately, the internal audit units sometimes are still improperly structured under Finance Departments and report to the CFO, and are considered as a low significance activity. Changes in the IIA definition of internal auditing however reflect the growing volume of its functions and differences in the responsibilities and the status.

Year 1947: 'IA mainly deals with the accounting and financial issues.'

Year 1957: 'IA is an independent appraisal activity established within an entity to control its accounting, financial and <u>other transactions</u>.'

Year 1971: 'IA is an independent appraisal activity established within an entity <u>to control its operations by providing a service to the entity</u>.'

Year 1981: 'IA is an independent appraisal activity established within an entity as <u>a service to the entity</u>.'

Year 1991: 'IA is an independent appraisal activity established in an entity to perform examination and evaluation of operations by providing a service to the entity.'

In Year 1999 a new definition of internal auditing was developed by the IIA

Internal Auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations.

Internal auditing 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.

There are several IA definitions used in the Latvian legislation, too, the scope and the meaning of which we will try to compare.

1) One of the first IA definitions in Latvia is given in the CM Regulations No 342 'Regulations Regarding Internal Audit' (05.10.1999):

'*Internal audit is the evaluation of the internal control system of an institution, which provides recommendations for improvement of the system in order to ensure effective operation of State administration*.'

2) ***Internal audit – independent and objective activity performed by an internal auditor and the objective of which is to improve the operation of the Ministry or institution verifying and evaluating systematically the quality and efficiency of the internal control system of the Ministry or institution and providing recommendations for the improvement of such a system*.** (LR Law 'Internal Audit Law', 20.11.2002)

By comparing the above given definitions it is obvious that the definition included in the IA law finalises the scope of the definition given by IIA in the aspect of performance of the state administrative functions while referring, however, to the evaluation of the internal control system and the development of recommendations for its improvement. We saw before that the reference to the internal control system evaluation is excluded from the IIA definition; the level of the state audit in our country, however, has not yet reached the stage for the internal audit to be able to focus solely on the risk elimination.

1.4. Regulation framework of internal auditing at the international level and within Latvian legislation

A significant turning point and the reason for development of internal auditing and therefore also for the strengthening of the ICS was the investigation carried out on the Watergate case in 1973-1976 when the USA legislative and supervisory body focused on the flaws in the control system allowing for donations by the largest USA corporations to domestic political organisations and bribing of foreign officials. In the result of the proceedings the Foreign Corrupt Practices Act was issued in 1977 requiring to provide for and carry out the internal financial and management accounting systems control. Corporations, professional organisations and supervisory bodies reacted accordingly trying to realise what would be necessary for them to do, what would be the most significant principles underlying the control activity and to identify what cost-efficient measures should be undertaken. In 1974 the Cohen Commission by reviewing the responsibilities of auditors requested from enterprises the disclosure of their annual status of their control systems, while in 1979 the Securities and Exchange Commission recommended its set of regulations for management reporting on the status of the enterprise internal control system. Then several ICS research projects followed.

Interest about these issues increased even more when in 1985 the US Congress sub-committee began the hearing process after several large corporations filed for bankruptcy. Questions were raised concerning the management capacity, adequacy of financial statements, quality of independent audits and internal auditing standards. It was recommended to develop a law that would require public companies to perform the evaluation of control systems and to submit reports with the opinion by independent auditors. The legislation was not changed on that occasion, but IC became an essential requirement for legislative bodies, supervisory bodies and professional organisations. The first legislative act providing for the requirement to publish the accounts was adopted in 1991. The Federal Deposit Insurance Corporation Act, applicable to banks, stated that the evaluation of the control system should be based on previously established criteria in view of the large public interest. In this respect the *Treadway* Commission or the National Commission on fraudulent financial reporting established in 1985 is also known world-wide. It was founded by the AICPA, American Accounting Association, Financial Executives Institute and the Institute of Management Accountants. The main objective of the Commission was to detect the causes of errors in financial statements and to suggest measures for their elimination or prevention. Commission report pointed out:

- appropriate control environment;
- code of conduct for the employees;
- effective audit committees;
- active and objective internal audit department.

As a result of the report the Committee of Sponsoring Organizations of the *Treadway* Commission (COSO) began its activities with the help of Coopers&Lybrand. Intermediary report was published in 1991, and the final report – in 1992. The report was based on the presently internationally recognised COSO internal control model.

One of the first audit committees in England was founded in 1896 in the Bank of England. It is not statutory in England to establish audit committees or internal audit departments in a public company, but it is a statutory requirement for real estate funds, local governments, health, educational and other public sector institutions. Also in England in the 80-ties there were many scandals and even cases of collapse of businesses. As a reaction to the low credibility of financial reporting or the inability of the auditors to ensure such credibility, the Financial Reporting Council, the London Stock Exchange and the professional body of accountants established in 1991 the Committee on the Financial Aspects of Corporate Governance. It was presided by ser Adrian Cadbury. The Committee prepared its report in 1992 and its contents became the nucleus for the Code of Practice for Internal Audit which was later extended and became the mandatory requirement for the London Stock Exchange on 1st January 1995. The Cadbury Code lays down the requirements for information to be disclosed in reporting. A special workgroup was given the task to develop a set of criteria for ICS efficiency evaluation. The criteria were based on the contents of the COSO model and grouped by the following areas:

1. control environment;
2. identification and assessment of risks, and the goals of control;
3. information and communication;
4. control procedures;
5. supervision and making of adjustments.

Further activities in supervision of operations and development of additional requirements enabled the Corporate Governance Committee to publish the Combined Code. The document includes the underlying corporate governance principles and their application. The London Stock Exchange must require from enterprises to disclose to the public whether the enterprise complies with those principles and their application.

There are several effective legislative documents in Latvia regulating the IA:

1) Internal Audit Law (20.11.2002);

2) LR CM Regulations No 306 **Internal Audit in an Institution** (10.06.2003);
3) LR CM Reg. No 305 **By-laws of the Internal Audit Council** (10.06.2003);
4) LR CM Regulations No 307 **Certification of Internal Auditors** (10.06.2003);
5) LR CM Regulations No 466 **Regulations Regarding Essential Requirements for Establishment of Internal Control Systems** (19.08.2003).

1.5. Comparison of internal and external auditing

In practice it is more common to meet the external auditors, besides it should be noted that the external auditor is a certified auditor or an employee of an audit firm performing the audit specified in the Law on Annual Reports for enterprises that if at least two of the following criteria have been exceeded:
1) net turnover of LVL 500°000;
2) the total balance sheet amount of LVL 250°000;
3) the average number of employees of 25 persons, then it is required for the enterprise to use the services of a certified auditor for auditing of the annual report. As the external auditors are also interested in the financial affairs and accounting, i.e., those issues that are also the areas of concern for internal auditors, it is logical to compare these two forms of audit by stating their common features and distinctions.

Table 1.1

Comparison of internal and external auditing

Basis for comparison	*Internal audit*	*External audit*
1. Persons performing the work and the nature of the function	Internal auditors are employed in special units, independent of other enterprise units	Physical persons holding the Sworn Auditors Certificate or audit firms having the licence, acting within the framework of signed contracts
2. Objectives	Independent appraisal of enterprise operations in the interests of owners, by giving recommendations to establish the most effective areas of development	Express an opinion on the truth and fairness of financial statements, elimination of information risk for third parties
3. Legislative basis	1) Guided by the requirements provided in the laws and regulations established for state	Acting pursuant to the LR law 'On Certified Auditors'

	administrative bodies; 2) Acting in compliance with the operating strategy defined by the enterprise owners.	
4. Management links	Vertical links in the organisational structure in line with the audit plan.	Horizontal links based on the contract signed.
5. Procedure of the auditing activities	Order, methods and techniques are defined by the internal auditing plan in view of the professional practice of IA.	Principles and procedures of auditing are defined by the International Standards on Auditing
6. Functions and status	The main functions, the role of IA in the organisation defined in the internal documents and the IA regulations	Main functions and status is defined in the Articles of Association of the audit firm and in the contract signed with the client.
7. Type of audit	Based on the examination of the evidencing overall or selective documentation and the operations performed	Using the systems-based approach in the evaluation of the annual reporting information as well as the IA results
8. Reports	The final audit report is submitted to the management, although the supervision over the execution of any changes made is also undertaken	Report to the management is submitted to the client, but the auditors' report is made available to all stakeholders

1.6. Internal auditing development stages

There are considerable differences in the development of auditing across various countries and enterprises. The most effective, however, is the IA which is consistent with both the professional standards and the needs of business.

The IA development could be divided according to 4 stages:

- traditional;
- conventional;
- advanced;
- 'false'.

Traditional auditing focuses on testing of financial transactions and testing of compliance with the laws and procedures. Typical characteristics of such an audit are the 'inspection approach', detailed examination of insignificant activities and the general atmosphere of fear and lack of trust. According to the assessment of international experts a great part of the work performed in such a manner cannot even be considered as internal auditing. It is more likely an attempt to replace the management supervision and control functions. Professionally the IA has left this stage behind already for several decades. It must be admitted, however, that in some enterprises this approach is still used, although this is rather due to the lack of knowledge than of a deliberate decision. Director of CATS International Keith Wade states that some European Commission auditors are still treating, implementing and promoting internal auditing exactly this way.

Conventional audit – this approach is being used by many auditors for a period of approximately the last 30 years. This is an objective evaluation of both the control system of any individual business process and the overall enterprise control system by providing the management and the board with an independent evaluation as well as with constructive proposals for improvements. Conventional audit implies a systems-based approach, professional behaviour, it focuses on the provision of valuable and reliable services in cooperation with the management and its area of activity is practically unlimited covering almost any business issue or operative concern.

IA provides assurance regarding the structure and operation of the control and risk management systems, draws the attention of the management to essential issues of control and management as well as provides the management with the necessary support in the implementation of any changes. The main objective is to collaborate with the management, executives and the personnel in order to strengthen the effectiveness of the control mechanisms by any reasonable means. A more practical option of conventional audit includes the so-called result (or performance) audits, fraud investigation, special projects and the consulting activities.

Advanced audit – reflects the best international experience and practice, and aims at more than required in the regulations by taking account of all day-to-day processes, for example, requirements by top management, the dynamic circumstances (environment) in which the enterprise is operating (including the effect of continuous information technology upgrading and development and the opportunities and threats caused by e-commerce) as well as the ever changing business needs, processes and units. Of course, what seems to be advanced in one audit department – may turn out to be a regular practice in another. In fact, everything described by the scientists as advanced methods is actually based on the principles that have been known and accepted long ago. For example, also the 'risk-based audit' is nothing new. The systems approach defines that an auditor upon preparation of strategic and objectives plans must identify and assess the most significant risks by evaluating the main control mechanisms as well as preparing the report on the findings during the audit and the possibilities for improvement.

The COSO internal control model has become a common international control standard, but there are other possibilities, too (the criteria developed by Alan Turnbull in Great Britain, as well as the Basel agreement of principles for the assessment of banking control systems to an extent are based on the principles of the COSO model. Many auditors use the COSO model as the basis when performing audits both at the operational and the strategic level regardless of whether the enterprise uses that approach or not. It must be admitted, however, that taking the human judgement into account, which is characteristic of advanced managers and auditors, is not directly included in the COSO model, but this considerably affects the effectiveness of control interactions. On the other hand, the COSO model is not perfect either and in some cases it may not even be applicable, for example, in some quality management or business excellence models.

This does not mean that the auditors of the advanced audits:

1) adjust, rather than only automatically accept these general models;
2) recognise that, although the underlying principles may not be anything essentially new, these models may provide with a new insight or stimulus for a fresh, more 'lively' audits;
3) understand that many auditor functions can be and even should be undertaken by the manager; the methods and competencies of conventional auditing can be taught to others, and new methods (for example, self-assessment of controls) must be recognised as a management instruments and responsibilities.

'*False*' audit There is an opinion that as the role of auditing increases auditors could come up with different tricks to justify their existence and to achieve greater recognition. Contemporarily internal auditors rarely perform 'the traditional works which are not the responsibility of auditors' – counting of cash, stock-take, testing of invoices, testing of compliance. Others are afraid that auditors could overestimate their capabilities by undertaking assignments outside their capacity in terms of resources and knowledge. Both theoretically and practically there is a very vast difference between consulting and internal auditing, although recently consulting has been recognised officially by including this function in the IA definition.

If auditors will take a more active part in the improvement of control mechanisms and handling of different problems their independence may be at risk. A certain part of theoreticians, however, promote the following view: 'If you're not the solution, you're part of the problem'. Therefore emphasising that the essence of auditing, its ultimate objective is to help minimise the need for auditing in general. Contrary to this view is another saying that the greater the difficulties of an enterprise, the better for the auditors (they have more work to do).

Checklist for Subject 1

1. ***What factors affect the internal auditing development process?***
2. ***When and in which countries the first forms of internal auditing were historically established?***
3. ***What are the tasks and the role of the International Institute of Internal Auditors in the development of IA world-wide?***
4. ***How the area of application of internal auditing changed over the period from 1947 till today/***
5. ***How should the concept of 'assurance and consulting' be understood in the definition of internal auditing?***
6. ***What features are common for internal and external auditing and in what aspects they differ?***
7. ***According to what criteria is the development of internal auditing divided in the following stages: traditional, conventional, advanced and 'false audit'?***

Practical assignment – prepare a summary about the scope of national legislation in the area of internal auditing.

Subject 2

Scope and Basic Principles of Internal Auditing

2.1. Concept of internal auditing
2.2. Scope of internal auditing
2.3. Principles of internal auditing

2.1. Concept of internal auditing

As it has been already given in the definition IA is an independent and systematic evaluation of adequacy, application and effectiveness of the control system of an enterprise or organisation. Its scope covers all activities of an enterprise or organisation and business issues and penetrates into all management authority levels. It examines, evaluates and reports on the status of control as a part of the input into a proper management of affairs, is aimed at effective and efficient use of resources and achievement of goals in line with the established enterprise business standards.

Responsibility at the IA level should be outlined as an obligation to provide professional support services to the management and the supervisory board, if any, in order for them to be able to perform their obligations and be assured of a proper and successful course of business. The opinion of internal auditors is considered to be an objective expert estimate secured by the methods used in the process. This estimate contains informed advice on the financial and operational systems control plan, its functioning and the effects on the enterprise and on the various processes and structural units. Auditors opinion is a product of evidence and judgement and should be supported by professional auditing procedures, stated facts, reliable decisions, understanding of business.

Objective The simple objective of IA is to assist in strengthening the enterprise control system by any suitable means. Therefore IA is not solely the performance of the auditing activities. It includes the provision of advice on issues of control, education and training, assistance to the managers in the self-management of control. Therefore, the objective of IA is *to promote effective control in the enterprise as a whole by the most optimal consumption of resources*.

Role of IA The role of the IA is triple:

1. to provide reasonable assurance about a proper system and functioning of the management control activities and procedures in forming a judgement about the general control level and attitude towards control;

2. to make the management alert about significant control errors that have already incurred material damage or failure of business transactions, as well as about any other undesirable events (at the same time IA makes a note of and highlights the strengths of control and the excellent performance in this area);
3. to render a partial constructive advice for improving the control, risk management and the solution of certain problems, and the improvement of business performance.

IA in general focuses on the future and it should ensure that the management and the personnel recognises, understands, accepts and applies those means and control procedures that are sufficiently powerful to solve not only the present problems, but were also capable of addressing any uncertainties and future changes.

By carrying out their role in the activities of the enterprise, the responsibilities of internal auditors are as follows:

- focus on the enterprise objectives and the means for their achievement within the existing and a larger business environment;
- keep alert regarding any kind of business risks: significant losses, errors, incompetence, irregularity, ineffective transactions, shifting away from the set standards, lost business opportunity, as well as the probability of and the possible effect of the risks named above;
- approve clear and consistent criteria according to which the performance of the control system and the transactions should be measured;
- gain sufficient, relevant, reliable evidence in order to provide valid judgement at the level of control risk and performance, and to convince the management about the need for improvements;
- discuss with the management and the personnel their interests, activities, conditions and views regarding the inherent and detection risk – as well as the results of the auditing work performed;
- report on the findings in objectively, accurately, immediately and with due confidence in the most appropriate manner;
- show to the management that the necessary degree of control can be obtained at an acceptable cost – the duty of auditors is to act as a catalyst and to highlight areas for improvement;

- be professional at all times and be responsible for following the standards;
- add value to their enterprise that can be demonstrated.

The level of development of different auditing functions varies. This means that also by taking into account the inevitable limitations present in the IA process the performance will be lagging behind the best practice in this area. Often clients may wish to receive from internal auditors what is even outside their scope. For example, detect fraud, perform detailed investigations of certain activities and write new control procedures.

It follows from the above said that IA *is neither inspection nor performance of specific functions*. It cannot be considered equal with a regular internal control, for example, verification of the employee personal identification data, supervision or management control, and cannot form a part of such internal checks. For all measures including the review procedures there must be an established system in the operations of the enterprise which is independent of the auditing activities. K. Wade wrote in one of his publications: 'Internal auditor is not a sniffer, policeman, inspector, problem-solver, penny-pincher or fraud detector.' It should be clear already that a modern auditor is a business analyst and is no longer interested in issues of low significance and does not deal with the financial transactions, inconsistencies and errors.

The adoption of the best audit practice clearly shows the support by the top management, the awareness, characterises audit managers as competent employees and the way the management should present the role of auditing in the enterprise. However, it is important for the auditor to look after his image, facilitate mutual understanding and trust, create respect and agreement on behalf of the management and other personnel.

2.2. Scope of internal auditing

IA has developed from the approach of checking financial transactions to covering of entire transactions taking place in the enterprise. For example, the standards of the UK Government Internal Audit Manual begin with the following statement regarding the scope of IA: 'The scope of IA shall comprise the entire enterprise internal control system.' This includes all transactions of the enterprise, all current or operational issues and all management objectives. There is a well-known statement: 'Audit is business. Whatever refers to business also refers to audit.'

For practical reasons audit planning is undertaken for the identification of the scope or objectives of auditing. During this stage the difficult decision regarding the balance between the width and the depth of auditing must be taken. If the resources are limited, an excessive scope may result in a superficial opinion. However, detailed testing of the areas selected may result in neglecting other areas. Often auditors are frightened to leave something out or not provide full assurance. Therefore, the audit scope must be agreed by all parties involved and any variations must be discussed with the personnel in charge.

Terminology There are various types of audit known: financial audit, efficiency audit, management audit, operational audit, work performance or compliance audit, transaction cost-effectiveness audit etc. They simply reflect different perceptions of internal auditing and emphases in the course of audit. However, one must see the distinction between the above mentioned terms simply reflecting various edges of modern internal audit, and the new forms of internal audit that have occurred in the recent years, for example, ***quality audit, environmental auditing, academic audit, medical audit, security audit etc.*** Unfortunately these terms have countless variations and explanations which only deepen the confusion. The term 'audit' has lost a firm basic meaning and is applied to any type of examination or control. In practice the work has to be coordinated with other structural units in order to avoid duplication and misunderstandings and to use the resources more purposefully.

Specialists distinguish between 6 dimensions of the audit scope:

1. area of activity (core and auxiliary businesses of the enterprise)
2. management levels in the enterprise that the internal audit is concerned with (strategic, tactical and operational);
3. scope of business issues or general control objectives;
4. management process (human resources management, projects, contracts, resources, status quo, changes);
5. the timing of audit assignment (before the event, during the event and after the event);
6. audited units (departments, business units, location, responsibilities).

Let us consider each of these dimensions individually.

(1) – area of activity

The scope of IA covers all business areas of the enterprise. Therefore auditing covers the financial and operational systems, open transactions, special programmes and occasional projects, team and individual employee functions, larger and smaller activities. Modern auditors focus on highly complex systems and any significant results achieved by the enterprise, and they are trying to provide a high-value service consistent with the needs of the management and addressing the most important and relevant issues. Attention is paid to control over different interrelated business processes. Therefore the scope of the IA activity includes work performance measurement systems, business planning, change management, setting of objectives and goals, identification of opportunities, budget preparation, quality control, assurance and risk management system, customer satisfaction, contract management, post-emergency recovery, product development, intellectual property, employee development, reputation risk management, environmental management systems etc., besides all in addition to the normal course of business, for example, marketing and commerce, production, procurement, human resources, transport, capital schemes, information technologies, share transactions, finances and accounting, centralised services and administration, research work etc.

Extension of the scope outside the financial area and transactions has led to the development of the so-called 'operational audit', i.e., an independent assessment of any of the enterprise activities: management, administrative, commercial, technical, financial or any other. Decision must be made by the audit that either it cannot and shall not provide the full assurance or comprise every area of activity of the enterprise. The underlying systems, main risk areas and priorities must be defined.

In practice the scope of audit may be limited by any choices made, circumstances, possibilities or other aspects. In theory auditors should be eligible to access all of the information, documents, premises and employees as they consider appropriate for the performance of their responsibilities, and this eligibility should be included in the audit statutes or technical documentation. Regardless of the above determination of areas of exemption, creation of official or unofficial barriers, non-provision of full cooperation is possible.

(2) – management levels

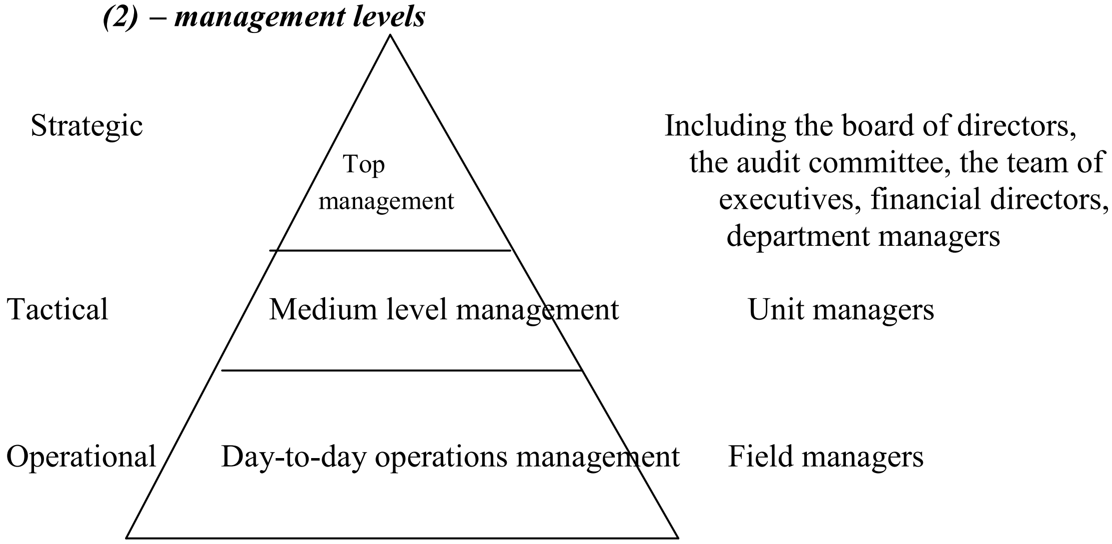

Figure 2.1. Hierarchical management pyramid

Within an assignment the emphasis can be laid on specific aspects of activity: project management issues, human resources management areas, computer systems, financial procedures, general control environment etc. Systems may be treated differently. During the process of some audits decision must be made as to the extent of the audit scope outside the borders of the enterprise. For example, if the systems comprise procurement, contracts, clients or other external factors. Probably it will not be easy to draw the border and the powers will be limited. Particularly this refers to the outsourced activities, joint ventures, affiliate network etc.

Audit should affect all three levels (see Figure 2.1.).
Auditing is increasingly directed to the top of the pyramid by examination of the higher level management processes, corporate plans, activities and decision making and organisational structures. Many of the difficulties found on the operational level are the result of the problems unsolved at the top level. Auditors must examine the most significant issues. When the top has been reached and the strategic perspective of the audit is adopted the direction can be changed from top to bottom.

Involvement in the higher levels introduces the auditors with the policy issues and the issues of strategic decision making. Internal auditors should not question the political objectives and decisions and they should neither substitute the policy-makers. However, policy is an area of activity of auditing because it is necessary to evaluate the implementation of the policy, its performance and efficiency, and in particular the adequacy and effectiveness of the measures undertaken, in order to formulate, implement, control, review and revise the political decisions.

(3) – scope of business issues

Audit relates to everything that the management is concerned about. It can be compared to the general organisational goals, important business issues or general control objectives. Therefore the potential scope of IA covers all control systems established in the enterprise in order to ensure a specific level of assurance about the following:

- Accomplishment of goals and objectives to set standards of quality and performance;
- Compliance with internal policies, practice and procedures and appropriate external laws, regulations and obligations;

- Reliability, completeness, timeliness and usefulness of financial, operational and management information and the integrity and completeness of the underlying records;
- Regularity of transactions and probity of conduct;
- Economy in the acquisition and use of resources and efficiency of operations;
- Safeguarding of assets, resources and interests against loss or harm.

Some issues will constantly be of concern, for example, control of payments, increase of income, customer satisfaction, maintenance of image and reputation. New issues will arise, for example, healthcare, safety and environment. Corporate governance and business ethics is certainly the main issue in the social, private and the voluntary sector. The new laws must be obeyed and as the world changes, so should the audit.

It is important to distinguish the control objectives from the audit objectives. To ensure compliance, to achieve economy, to safeguard the assets and to attest the security of information – these are not the primary audit objectives. Auditors should rather exercise due care to identify, evaluate and test the controls put in place by the management for solution of such issues. Do the mechanisms exist and operate successfully to give the management the necessary assurance of the level at which these basic control objectives are provided?

(4) – management process

Managers have many responsibilities and management takes many forms. Control should not be detached from planning and other aspects of the management process, and an auditor is interested in helping the managers in the fulfilment of their responsibilities in managing business processes, projects, interrelations, technologies, information, people, resources, situations, changeovers, risks and self-control.

Although the main emphasis is directed at control, audit scope also includes all of the activities when the management functions are overlapping: guidance and management, organisation, communication, decision-taking, planning for extraordinary situations etc. How do the managers handle challenges and changes? How do they handle specific tasks and performance measurements?

(5)- timing of audit assignment

Regarding the timing when the auditor commences his work the views of the specialists must be given: ‘Control after death is not an objective of internal audit, although auditors have the reputation of historical researchers – they arrive when the battle is already lost and are stabbing the wounded with the bayonet.' This is a wide-spread opinion of the nature of auditing, but incorrect, however. Modern auditors must address the existing processes and their activities are oriented towards the future.

Therefore, the audit scope includes the involvement in all life cycles of an enterprise – and the earlier, the better. The form of such involvement is an independent assessment of the established forms of control in regard to the development of new systems, coordinated process of existing operations and change planning and implementation.

It is easily recognisable in the audit of computer systems or capital projects, but it applies to all activities. Therefore auditing refers to the overall control of the entire project, to the control embedded in each new system and the control existing in each main stage of each system life cycle.

(6) – audited units

Any business unit is included in the scope of audit regardless of how it is being organised or treated: operating unit, inter-department business process, subordinated or foreign branch, specific location (for example, school workshop) or anything else. Enterprise reorganisations have changed the organisational structures and have moved away enterprises from the strict department operation approach in business management. In the same way as audit enterprises have also begun to use the cyclical approach which exceeds the borders of structural units. However, it should be taken into account in auditing that the structural units and specific entities will still continue to exist. The audit scope comprises all enterprise units and their interrelations. Decentralisation, authorisation, tele-networking, partnership and expulsion (one enterprise squeezes out another from the market) brings along its specific control concerns that need to be recognised and resolved by internal audit. Contemporary enterprises are rapidly changing and adaptive, and so must be the audit.

Modern audit does no longer audit a specific location as it was before, when local visits were made, and this was in fact the management audit. Audit should not be confused with an inspection visit of an enterprise, its affiliate or a specific unit. Auditing of purchases should not take place in the procurement department, but rather comprise the entire purchasing process from the start to the end by including all structural units and employees involved. Often many control problems can be found particularly in the interactions between different structural units, while this aspect is frequently ignored by the auditors.

An enquiry made at the end of the 20th century by the United Kingdom Institute of Chartered Accountants in England and Wales disclosed a broad variety of the work performed by the IA departments in both the private and the public sectors. The distribution of time used in audits in average proportions was as follows:

Operational and business processes	30%
Financial audit	24%
IT systems audit	13%
Special investigation and fraud related work	10%
Regulatory compliance work	7%
Other areas (each)	4%

Cash investment efficiency audits
Control self-assessment
Assistance to external auditors
Environmental issue audits
Contracts signed with joint ventures
New products

There is another dimension, however, – some audit departments still perform the so-called 'non-audit' services, sometimes voluntarily due to lack of knowledge, but sometimes by obeying the orders of management. What are the most common 'non-audit' works? The examples are given below.

- Operational assignments – involvement in functional activities or their execution.
- Internal control – cash counting, compliance control, repeated control, quality control etc.
- Attestation – reconciliation of accounting data with the inventory, substantive testing for external auditors, authorisation of payments, undertaking the role of assurance providers, other types of replacements either before or after the event.
- Activities in critical situations – if anything goes wrong, the auditor is consulted.
- Special projects – for example, fraud investigations
- Consultancy – initiated by the auditor or on request by the management (planning or development of procedures for new systems or the realisation of other requests).

The borders of auditing are being regularly re-defined, but the basic concept of auditing should remain firm – the recognition of the essential nature of internal auditing and the need to adopt a systematic instead of a single assignment-based approach.

2.3. Principles of internal auditing

Principles are the basis for development in each profession. They are included throughout in the standard rules of practice and conduct. They must be generally applicable by nature and unambiguous by interpretation, while allowing for some flexibility and diversity in practice. The true principles of IA must represent and support the substance and the purpose of activity.

There are 22 essential principles.

1. Role of IA – its main objectives that distinguish it from other functions and assessment activities and justify its existence.
2. Independence – including objectivity. Independence is complex, relative and critical.
3. Authorisation – the position, status and 'eligibility' of audit; support and assignment of some powers must be provided to audit, however, audit is an advisory rather than executive function, therefore audit does not have any linear power.
4. Service orientation – customer focus, meeting of the needs of the primary and secondary clients as well as interest groups.
5. Due care – the fulfilment of the concepts in a professional, competent and efficient manner, the development of useful conclusions based on carefully and correctly obtained and evaluated reasonable evidence.
6. Ethical conduct – definition of a set of moral values and due conduct in addressing different situations as well as in maintaining relationships with other people, demonstration of integrity.
7. Scope – the possible extent of the auditing assignment including all business activities, care and control mechanisms in every enterprise or organisational level.
8. Selection – the rights and the need to choose, which activities, systems and transactions would be verified.
9. Materiality – auditing of those items that are important, avoiding insignificant items, reporting only on significant issues.
10. Judgement – auditing is rather art than science; it is the process of assessment leading to opinion. Any opinion, however, must be professional rather than subjective; it should be based on physical evidence and logical thinking as well as the judgement of others should also be taken into consideration.

11. Comparison – comparing the situation against objective criteria, including recognised standards, required procedures and best practice.
12. Consistency – consistent conclusions and consistency (instead of uniformity) of approach in different time periods and assignments of different auditors.
13. Best audit practice – structured, systems-based participation approach, which is in compliance with the professional standards and uses the most appropriate and modern techniques.
14. Working with people – the partnership approach; the most important skills are the skills of interrelation including the ability to communicate, conduct meetings, to achieve cooperation as well as to persuade.
15. Confidentiality – disclosure of information to third parties only if expressly permitted and necessary.
16. Future orientation – auditing for the future, assisting the enterprise in handling any changes and future events, involvement of independent audit in future projects and systems to be designed; the auditor serves as a catalyst of changes.
17. Cross-cutting concepts – understanding of the principles of business processes and their practical aspects, objectives, risks, environment, control and management.
18. Continuity – internal audit is a full-time activity (the fact that auditing is a continuous activity does not mean that auditors must anytime and anywhere be present).
19. Reliance – managers should generally rely on their control mechanisms rather than on audit, audit will provide a certain degree of assurance, but it will neither provide any guarantees nor assume the linear management responsibility, the role of audit is to increase self-assertion.
20. Added value – provision of an approved quality and business-oriented service that would be adequate, useful and recognised and would lead to a greater assurance and continuous improvements of business control mechanisms and work performance; all audits must be manageable, justifiable and useful.
21. Reporting – form auditors, due to their critical role, much larger reporting is required than from any other personnel about the use of resources, compliance with the work standards, achievement of goals and the efficiency of their own control mechanisms.
22. Humour and joy – sense of humour is a vital feature and audit can bring joy.

Now, let us discuss each of the above mentioned principles in detail.

1. Role of internal audit

Consequently, according to the above given IA definitions, IA provides assurance to the managers as to the adequacy of the control systems designed by them, correctness of operation in practice and the extent to which they are capable of achieving their objectives. IA will alert the relevant management levels about the weaknesses and problems of control that have already occurred or may still occur as well as provide advice to the mangers on how to strengthen the control mechanisms, and, if the auditors have the relevant qualification, then – also how to resolve the problems identified. Auditors must be constructive and suggest any corrective actions; however, they should cautiously consider the extent to which they would assist the managers in strengthening the processes, resolving the problems as well as performing other duties under the responsibility of managers. Therefore, the primary 'product' of audit is a balanced, informed, neutral opinion regarding control. Material findings, for example, errors, inefficiency, breaches etc. may have significance of their own, but these are still by-products obtained mainly for the purpose of providing evidence for substantiation of the opinion.

A modern audit function consists of the following two elements:

- Regular activities for examination and improvement of control mechanisms; and
- The extra value added work comprising the whole range of further services including efficiency studies, consultancy services and other responsibilities the purpose of which is to improve the performance.

The IA objectives should be based on the objectives of the entire enterprise. Its intentions, values and culture must represent the intentions, values and culture of the seed company. The enterprise business objectives are the starting point in each audit assignment.

2. Independence

Independence is one of the two main reasons justifying the existence of internal auditing (the other is the audit expertise in terms of control). Independence allows auditors to give opinions which are free from bias and submit neutral recommendations. Audit independence is ensured by its respective status in the enterprise and objectivity, but it can be compromised if inappropriate influence is exercised, if the incorrect audit position in the enterprise and in the chain of subordination is selected and if conflicts of interest and private interest tendencies arise.

Independence should not be treated as full autonomy, freedom and self-determination. IA will always be to some extent dependent on others as well as reporting to others.

In order to reduce the complexity of independence 6 aspects can be distinguished.

- position – separate department, operating full-time, segregated from any executive functions and having an appropriate status in the enterprise;
- subordination – reporting to top management levels and officials, having direct access to the management board and the audit committee, but communicating and submitting direct results to the managers of appropriate authority levels without influence from others;
- scope – unlimited inclusion of any enterprise issues and activities, the audit plans are established by the auditors, have the right to decline requests, eligible to access all locations, employees, assets, records and information;
- function – internal audit department bears no operational responsibility or executive responsibility for the linear activities, development and implementation of new procedures and systems, internal controls, decision making; IA may not substitute those activities that would have to take place anyway without the presence of audit, audit is not an available labour resource;
- resources – own budget sufficient for the execution of responsibility assigned, a certain degree of freedom regarding appointment of employees, their salaries and work conditions; only the enterprise top level management may appoint, formally sanction and lay off the managers of IA departments; the time of auditors may not be requested for any other assignments apart from the performance of audit assignments or any agreed assignments;
- state of mind (objectivity) – exclusion of personal interests, superstitions, unsubstantiated generalisation and ready-made conclusions; avoiding conflicts of interest; keeping integrity and trust in audit work; keeping the balance in all issues; resisting the influence and pressure from others; avoiding unjustified reliance on others; awareness of potential areas of stumbling in implementation of the participation approach in auditing, awareness of the effect of salary payment and other types of dependence.

Independence is a very important. Auditors must be on the alert for situations that may compromise objectivity and minimise independence, therefore, appropriate safeguards must be created. Independence, however, cannot be used as a justification for isolation, arrogance or exclusion of other people where the situation requires the opposite.

Likewise independence does not exclude some forms of participation and engagement as an inseparable part of the enterprise.

3. Authority

Audit authorisation includes the rights and powers, and the support received by the audit. Auditors do not have a linear authorisation, including their own duties to be performed. Auditors may not give instructions, may not insist on the fulfilment of their recommendations, and neither ensure the performance of the respective actions. This is a management prerogative to either accept or reject the advice given by the auditors, by giving the respective explanation and being aware of the risks involved.

Auditors, however, must have the authorisation to direct the issue for reviewing 'upwards' to the highest management levels or the audit committee, if necessary. Linear managers must understand the authorisation of the auditors and respect their professional views. They are paid, however, for decision making and operations management after due assessment of all factors, including the comments and advice by internal auditors. Assistance to the audit work, however, can be provided by providing strong support from the top management and the audit committee. But the auditors are not right just because they are auditors.

Internal auditors do not have the authority to report without a permission on the enterprise affairs to external persons if the law or the regulations do not expressly require to do so. Audit authorisations are usually limited to the respective enterprise, but a necessity may occur to request a special permit to investigate some issues which exceed the borders of an enterprise (for example, a clause in the contract allowing the auditors to get introduced to the accounts and operations of suppliers and contractors).

4. Service orientation

Users of audit services should be considered as 'customers' or 'consumers' rather than victims. The service provided should be adequate and useful, and satisfy the needs of the customers to the greatest extent possible. However, audit clients are not always right: their intentions can be wrong and other factors can turn out to be more dominant. Intentions must be managed, customers educated, but their requirements which are sometimes conflicting must be coordinated or at least balanced. The primary and the secondary customers must be identified, their needs assessed and prioritised, as well as the respective audit respondent action plan developed. Customer satisfaction must be measured and the necessary adjustments in the audit process made. Likewise the interests and requirements of other stakeholders must be taken into account. Internal auditors need a marketing plan for the sale of their services. It may be useful to prepare some guides explaining the internal audit role and processes as well as to draft covenants that would serve as an 'agreement' between the parties.

5. Due care

Internal auditors cannot provide absolute assurance about the systems reviewed. They have, however, an organisational and a professional obligation to carry out their duties with due care, adopt and comply with accepted audit procedures and standards, as well as to obtain sufficient and verifiable evidence for the justification of their opinion regarding the adequacy, application and efficiency of the control mechanisms. Whether it is the obligation of the auditors to perform further investigation (or just report to the management) in cases of suspicion is still quite unclear. Auditors must be aware of the different risk factors associated with such activities. It is not the same as being obsessed with finding of fraud and errors. 'To be observant' is not the same as 'to search'. Auditors are not detectives.

Carefulness means prudence rather than caution and requires persistence, reasonable judgement and efficient supervision. Auditors cannot undertake (and they should not be assigned) tasks for the performance of which they lack experience, competence and confidence. It is not easy to define what could be reasonably expected from an auditor. Not all auditors are properly trained. Irrespective of this, the minimum standards of conduct, practice and achievements must be defined, the measures specified, instructions provided, clear guidelines stated regarding what is expected of the auditors and how they should act in special situations, for example, if any suspicion of fraud arises.

Due care requires that the auditors understand the system and the situation. A professional, efficient and useful audit depends on a well-designed audit process. Usually this would be a systems-based audit. Due care and technical professionalism must be applied during every stage of audit.

- planning and preparatory work for the audit assignment;
- identification and registration of the system to be tested;
- evaluation of the primary control mechanisms;
- testing of applicability and efficiency of control mechanisms;
- assessment of audit findings;
- reporting the results and follow-up on implementation of the recommended actions.

6. Ethical conduct

The Institute of Internal Auditors (IIA) maintains the view that it is unethical for an auditor to undertake an assignment for which he is not competent. There are 11 standards of expected conduct included in the IIA Code of Ethics that need to be complied with if the members of the institute wish to realise their responsibility towards those serving it. These standards cover the following issues of moral and personal conduct:

- integrity, objectivity, respect;
- loyalty towards own enterprise;
- involvement in illegal or unacceptable activities;
- involvement in activities discrediting the profession or the enterprise;
- conflicts of interest and issues adversely affecting objectivity;
- acceptance of material values that could be influencing (or could be considered as influencing) professional judgement;
- compliance with professional standards;
- correct use of information (confidentiality issues, deriving of private benefits, activities deteriorating the welfare of the enterprise or illegal activities);
- disclosure of all material facts;
- constant efforts to improve professionalism, efficiency and quality of the service;
- determination to maintain high standards of competence, moral, respect, as well as to enforce the goals and requirements of the institute.

Often conflicts and complicated issues may arise for which there is no single answer. For example, what should an internal auditor do if the enterprise practices wrongdoings, conceals such actions or justifies it. Does an auditor have a professional, moral or even a legal obligation to disclose it to any external controlling institutions, especially if his own efforts to seek good conduct have failed. Ethical dilemmas are nothing unfamiliar; they are created by human relationships, personal values, special conditions or other conditions. Large deviations from acceptable conduct are rare phenomena, but they happen. Some internal auditors have even been to prison for fraud.

7. Scope

We have already looked at the audit scope in a greater detail in the previous paragraph. Still let us summarise again. The audit scope is limited only by the imagination of the auditor and the enterprise limits. In practice the audit scope is often limited by the availability of resources, the authorisation requested by and assigned to the auditor as well as the enterprise needs. When determining the scope of the audit work or a specific assignment, the 6 dimensions must be taken into consideration: the enterprise business processes, responsibility and location, structural levels, management functions, timing and business issues.

Furthermore, 7 core principles are cross-cutting the audit scope:

- auditing of significant issues;
- access to all enterprise activities;
- audit is the resource of the whole enterprise;
- involvement from the very start;
- work at the highest levels;
- interest in all areas of business;
- predict future activities and their requirements.

8. Selection

In principle, auditors must choose the most appropriate and important issues meaning that in practice they cannot be asked to look at any activity, system and transaction. The management may not agree with the auditors on the areas an priorities selected for auditing, and therefore it is critical to ensure that the selection process is clearly reasonable, based on objective criteria, appropriate consultations and rational considerations.

At the transaction level it would never be possible to check 100% of the activities and it is not even required. However, generalised conclusions must be made carefully.

At the corporate level auditors often have to prepare an annual, assuring report on the most important issues (for example, on corporate management systems) or the overall controlling framework. Also in this situation it would not be easy to make general conclusions based on the areas selected for examination. Besides it is necessary to understand the distinction between a limited opinion about the areas audited during the respective period, the view about every control mechanism or control system and provision of assurance on the overall controlling framework.

9. Materiality

Auditors must examine those issues which are important to the enterprise itself and not to the auditor. Materiality of transactions and activities in should be assessed in monetary terms, but it must be remembered, that sometimes other aspects are more critical, but they cannot be expressed in quantitative measures, not mentioning monetary terms (for example, business image, management policy etc.). Audit planning, work on the spot and reports must focus on high risk and business-related significant issues. Auditors must identify and assist the managers in preventing the causes. Often audit findings are the symptoms of other, deeper-rooted difficulties often attributable to the system and enterprise top levels – communication problems, distinguishing the goals, accepting the responsibility or other. The collapse of the Bank Baltija is a clear example. If any problems arise at the top levels, then audit should start from right there – is a downward, systems-based management approach.

10. Judgement

Auditors are paid to express professional opinions based on properly interpreted and duly considered material evidence. Conclusions must be valid and developed in a rational way. Recommendations must illustrate a good sense of the circumstances and understanding. If necessary, also the opinion and affirmative (or opposing) judgement of others should also be taken into account.

Audit opinion must be balanced, by identifying both strengths and weaknesses. Experts believe that contemporary auditors need an uncommon combination of skills – analytical and creative skills. Logics alone is not enough. One must need passion and a creative approach by considering and suggesting new procedures, fresh ideas and problem solutions.

Judgement is required also in the process of auditing: selecting the areas of auditing, sorting and selecting evidence, deciding on further steps and working with difficult and untypical situations.

11. Comparison

Conceptually auditing is quite simple – it is a process in which the existing situation is compared to the one as it should be. However, the criteria and measures for comparison must be just, substantiated and objective. As far as possible, agreement must be reached regarding the standards of control, work performance and expected conduct as well as the benchmarks used in the process. The procedures identified must be compared to the conceptual control mechanisms, recognised standards, any set requirements and other best practice. Best practice, however, should be very carefully considered and adapted, instead of only taking it over, in order to ensure that it is suitable for the local conditions.

12. Consistency

Consistency is not the same as uniformity. It would be inappropriate to expect that all auditors would perform the same work absolutely in the same way. Although auditing requires individual skills and judgement, the reputation of the entire audit department depends on the specific actions of its employees. Consistency is necessary to ensure the maintenance of the standards and the effectiveness of the auditing process. Passion and enthusiasm should not be underestimated though: a balance is needed between the freedom of actions, on the one hand, and guidance, on the other.

Audited persons have the right to expect consistent actions from the auditors, consistency in comparable situations and at different points in time. The auditing standards adopted, reasonable auditing processes and efficient quality control ensure elimination of the inconsistency risk.

13. Best audit practice

Audit should mainly use a structured, a systems-based approach by involving other clients and persons in the auditing process as necessary. Audit includes its own control systems in order to ensure the fulfilment of the audit objectives, the compliance with the enterprise requirements and professional standards as well as the most efficient use of resources.

In certain conditions also other approaches could be appropriate (for example, detailed investigation). Regardless of which approach the auditor chooses, professional audit department must ensure that the implemented processes and techniques are modern, represent the best practice and conform to professional standards.

It should be admitted that numerous audit departments have obtained the ISO 9001 certificate. This would be advisable and useful, but does not, of course, automatically mean that the internal audit unit provides high quality and appropriate services. This simply confirms that the audit department is using approved procedures in the result of which specific quality levels are achieved.

14. Working with people

Good work relationships are an extremely important precondition for provision of cooperation and information acquisition. This is even more required to achieve the determination and efficiency: that the audited persons acknowledged the necessity of audit, believed and wished

to implement the developed recommendations.

There could be several obstacles impeding cooperation and the reaching of efficiency, including the lack of understanding or recognition for the role of internal audit, the natural resistance to being tested and the fear of criticism as well as the chance that the audit could really disclose some errors or problems.

It is easy to say that the auditor should depersonalise the auditing process and demonstrate that his object under consideration is the systems rather than individuals –

but these two sides can scarcely be distinguished. Auditors must be capable of forecasting different possible responses to their activities and choose the style that would be most appropriate for the circumstances, audit objectives and the benefit of the enterprise.

The appropriate style depends on the circumstances and combines friendliness, sincerity, compliance with the protocols, transparency, understanding of the situation, professionalism as well as the personality of the parties involved.

It is critical to carry out consultations during each stage of the process and the audit will become a more common activity involving auditors, managers and their subordinates all working together for reaching the common goal. There should be no surprises – at least not in the content of the report. Auditor should always remember that he is a privileged person with the rights of intervention. Power and privileges should be realised with the highest sense of responsibility by respecting the liability and authority of the managers.

15. Confidentiality

It is difficult to gain trust in auditing, but it is easy to lose it. Clear breaches of confidentiality will be considered as betrayal of trust. Relationships between the auditor and the audited person cannot be identical to a relationship between a doctor and his patient. Material discoveries must be disclosed, and auditors must act in the interests of the whole enterprise. Auditors however must be discrete and any disclosure of information to third parties outside the linear management should be viewed upon as an exception for which a special authorisation is required. Confidence in audit is based on an evident competence and confidentiality.

Certain structural units (for example, external auditors and other regulatory authorities) have the right to get introduced to the documents and information, including the audit report and materials – this does not mean, however, that these documents must be offered at the initiative of the auditor. If the auditor discloses the information to an external party voluntarily and without permission, he does it as an individual and not as an auditor or an employee and therefore he must be prepared to account the consequences of his actions.

16. Orientation towards the future

Modern auditors must have a future vision. Systems and circumstances change: auditors may facilitate the change processes and management. Control systems must not only ensure stability and the present system, but also help the enterprise to adapt to a changing environment and improve its practice and work performance.

Auditors are catalysts of change, they promote innovations and improvements. Auditors must take a critical view in the report on how managers respond to the audit recommendations and what techniques and assistance is required for the managers to be able to accept the necessity for a change and to implement successfully the new procedures and problem solutions. At all times the auditor must maintain the orientation towards the future: he cares not about what happened in the past, but rather – what happens in the future.

17. Cross-cutting concepts

This principle means that auditors must demonstrate that they understand and can promote this understanding in the business process of interrelations that are of critical importance to others between the objectives of control and business, risk, environment and work performance. More often auditors act as promoters and educators to assist the managers in identification of a specific risk involved in their activities and to establish appropriate safety measures based on the correct understanding of the concepts involved and their application.

Contemporary audit is a multi-disciplinary audit demanding a mixture of collective skills: accountancy, legal, political, behavioural psychology, management and further necessary skills. Yet the art of auditing is the application of general concepts to a specific transaction under consideration. Although auditors are also the experts of control they may be short of some specific knowledge in the area of 'technical' control mechanisms, for example, control software applications in computer systems, engineering control mechanisms in energy management systems, physical safety etc. Respectively, alternatives must be determined and decisions adopted: exclude such areas of competence from the audit scope, get an introduction on the issue within the scope of possibilities available for the audit, engage the necessary experts in the audit department, rely on the words or views of other people, or other possibilities.

18. Continuity

Audit is a continuous activity involving specially appointed and trained employees acting as an independent department and performing full-time work. Therefore, auditors may not be charged with other responsibilities. 'Continuity' does not mean that auditors must be in all places continuously checking everything. We cannot afford more controllers than doers, although practice proves that the number of auditors is rapidly growing. It means at least that an increasingly large number of people get used to the fact that they are being audited. Many consider auditing as an unwelcome and unnecessary intervention. Others view it as the cost of failure. In reality the goal of internal audit is to cancel itself out. The stronger the control mechanisms are, the less necessary auditing is, and vice versa. However, systems, control mechanisms and people are rarely perfect; times are changing and there will be always the need for independent entities providing the sense of safety and advice.

19. Reliance

Managers should not rely on auditors, but rather on the control systems established in their enterprises. They still have the right to rely in some extent to the audit opinion and to expect that it will be objective, substantiated with information and sensible. What level of security could be provided by auditors to managers should be agreed in a joint discussion on this issue by possibly involving the audit committee members in the discussion. The resources available, management needs, increasingly growing amount of work and competitive requirements should be taken into account there. Reliance on auditor expertise regarding control mechanisms and the related developments could lead to the fact that auditors assume, for example, the management of a quality assurance programme. Pragmatically, this wouldn't be wrong in the short-term. Still the sooner the auditors are released from these responsibilities the better, and the enterprise would have control management processes of its own.

20. Value added

The input given by audit should exceed the cost in any case. Financial audit costs are not the main factor, although – particularly in times of financial difficulty, management may adopt the decision to reduce the audit budget. Rather they should consider the costs of lost opportunities. Auditors are capable of doing a good job that clearly and directly adds material value to the business. Modern audit consists of two aspects:

- activities for testing and improvement of control mechanisms that should create extra value by itself;
- and further value added activities that could include efficiency checks, consultancy measures, elimination of problems and the whole range of other business services that are necessary or that nobody else is willing to provide.

21. Reporting

The IA department more than others is responsible for the achievement of its goals, realisation of its authority, use of its rights and resources as well as the exercising of power. It should be capable of showing that its control mechanisms are adequate, are applied correctly and are efficient in practice. It should vigorously perform self-assessment and subject itself to an independent evaluation of others. This should be the best-controlled function in the entire enterprise. If it is not so, then its reliability and further existence may be questioned.

22. Humour and joy

Sense of humour is vitally necessary in audit work. Auditors must be professionals in their approach, but it does not mean, however, that they should be stiff, resentful or arrogant. Auditors must be capable of establishing good relations with people, to present the case in the correct light and to enjoy life. The most important principle is that auditors must not only have confidence in their work and support its policies, but also do it with joy and gain satisfaction from it.

Checklist for Subject 2:

1. ***Describe the concept of internal audit by stating the object of its research, objectives and responsibilities of auditors***
2. ***How should you describe in detail the scope of audit or object of research?***
3. ***What dimensions of internal audit scope the scientists have identified?***
4. ***How to explain the need for the internal audit principles?***
5. ***Distinguish the most important audit principles from the set of principles and describe those principles.***
6. ***How the audit result – creation of added value to the enterprise, is represented?***

Subject 3

Organisation of Internal Audit Work – Overview of the Stages of Audit

3.1. Place of the international audit unit within the organisational structure
3.2. Systems-based approach to internal auditing
3.3. Description of the stages of auditing
3.4. Internal working documents and audit file

3.1. Place of the international audit unit within the organisational structure

Internal audit as a function can be performed in two ways:

1) by acquisition of internal audit services from 'outside', i.e., using services of audit companies or certified internal auditors based on the contracts signed; (in this situation certain problems can arise with ensuring the continuity of the audit function, however, the entire initiative and activities depend on the management of the enterprise management and its understanding of the importance of IA);
2) by establishing the audit structural unit in an enterprise and including appropriately trained and possibly certified internal auditors.

In the first case the management goals regarding internal audit are important and the fact, how these goals are presented in the signed contract as well as to what extent the contracting party ensures the quality of the benefits expected from them.

In the second case the entire audit-related work organisation takes place within the enterprise. Therefore, it is necessary to establish the structure of the IA unit personnel and their qualifications, the place of the structural unit within the organisational structure; develop the regulations of the internal audit unit, identify the resource requirement, including the budget assigned for audit as well as to resolve a range of other organisational issues.

One of the main conditions for the audit work to be consistent with the IA principles is the independence of its structural unit. This means that it should be subordinated solely to the board of directors, if any, or to any other top level manager. Historically a practice has been developed when the manager of the internal audit department was subordinated and reporting to the chief financial officer. Presently the situation, after evaluating the place of the IA in the organisational structure, has changed.

More than 55% of the IA departments visited were subordinated to the top management level.

The IA service must operate in the enterprise based on the effective state laws, the professional practice standards of internal auditing and the code of ethics as well as on the enterprise internal document laying down its development goals, strategy and tactics, and the content. IA department must have the following documents regulating its activities:

- regulation of the IA department;
- job descriptions of the IA department employees;
- calendar plans of the IA department activities;
- methodical instructions of the audit activities (for example, a manual)
- the IA professional practice standards etc. documents.

There may be the following sections in the Internal Audit Regulation:

1) General description – the exact subordination of the department to the top management, the regulatory legislative acts and direct responsibility for the labour organisation in the IA department is specified;
2) Tasks of the department – the most important and secondary tasks to be performed by the IA department in the area of ICS evaluation and additional services are listed;
3) Structure of the department – all sub-units are listed (divisions, offices, teams etc.) and the ties between them are described; the distribution of employee responsibilities; qualification requirements for the department manager and other employees of the department as well as the form of labour remuneration;
4) Functions to be performed – the objectives of the departmental work, the role and the work to be carried out for the attainment of the enterprise goals are described in detail;
5) Department competence - specifies the rights and obligations of the department employees;
6) Responsibility – responsibility of internal auditors is established for the performance of their tasks and the non-involvement in the performance of concrete activities is specified;
7) Connection with other structural units of the enterprise - the possibilities of obtaining information and communication are described.

The most qualified employee of the IA department is *the department manager* who is entrusted with the management and testing of the department personnel performing the specific audit tasks. *Manager of the team of auditors* establishes the audit plan-schedule and defines the order of work performance, completes its team, prepares the audit working plan and the programme, reports to the manager of the audit unit the main audit performance results that may affect the contents of the audit report. The team manager participates in the preparation of the work, makes, and documents, and systematises the audit working records, prepares the audit report and also participates in the process of supervision over the implementation of the recommendations developed. The main workforce for carrying out these tasks is the internal auditors who must upon execution of their functions observe the audit principles stated in the previous subject. In case of necessity auditors engage experts by setting out specific requirements to them. Expert is a specialist within a certain area, who is not an employee of the enterprise and who has sufficient knowledge, skills and competencies to express an assessment in the area audited. An agreement is signed with the expert; the results of his work are processed in a written form and included in the IA working documents.

3.2. Systems-based approach to internal auditing

A systems-based audit is a structured approach to evaluation of control within the framework of enterprise operations. The original purpose of the systems audit is to assess the scope within which the controls established in the enterprise are reliable. This approach by nature is both systemic and systematic. This means that any activities in this aspect are recognised as a system or a business process for which a strict, but also flexible methodology is applied.

Systems approach is an opposite of:

a) ***operational audit*** – focussing on detailed confirmation and proving of individual items (specialists believe that this is an extinct form);

b) ***investigation audit*** – which is a deep and performance-based form of audit and examines directly the results of the system (examination of value for money) or some specific details of the situation (for example, fraud investigation).

In systems audit the emphasis is more on the process rather than its final product, on the evaluation of structure and procedures rather than auditing the results. This is a modern type of audit, it is a way of thinking.

The first requirement for systems audit is to perceive an activity as a system, where it is necessary to exceed the physical or organisational borders. It should be understood that different people perceive one and the same system differently. A good way to help to 'see' a system is to draw it. Components of a system are as follows:

- business process;
- objectives of the system;
- risk;
- control;
- system environment and interrelations with other systems.

Business process – is the sequence of components involved in the activities (persons, documents, items etc.) and the events taking place with them.

System objectives – the objective of the audited activity, besides also the principal and the specific control objectives embedded in the system.

Risk – the possibility that the operations will not happen as expected. It must be identified and assessed.

Control – any management activity undertaken to protect from risk and facilitate the achievement of the goals.

The systems (or control) environment are the elements outside the scope of the system (the management culture and attitude towards control) and what defines specific systems. Environment affects and includes other systems that interact with the audited system.

Systems can be natural, theoretical or man-made, however, all of them have something in common. One must remember, however, that system is a subjective concept. For example, a building can be perceived as a house, operating structure, object of defence, investment etc. Each system is a part of a bigger system which needs to be taken into account when assessing the audit scope and limits. Systems audit starts with the identification, classification and analysis of the enterprise systems as part of the strategic audit planning. This helps the auditor to understand the enterprise operations, to see the relationship between them, assess their importance and role and to identify what should be included in the audit plan.

Auditors are interested in all 4 levels of the systems existence:

1) designing – requirement, assessment, definition, specification;

2) development – plan, development, testing, completion, changes;
3) operation - implementation, operation, evaluation, maintenance;
4) updating – adaptation, enhancement, redesigning, substitution.

Systems audit includes the identification, evaluation and selective testing of the management control system. Any audit goal is to give confidence to the management about the adequacy, application and effectiveness of control. In fact, auditors seek proofs that would allow him to establish 4 interconnected views on the planning and operation of control:

a) are all of the controls planned to enable the achievement of the goals and protect from risk? ('adequacy')
b) do controls operate correctly in practice? ('application')
c) do controls operate successfully? ('effectiveness')
d) what is the general status and business control quality in this area? ('opinion about the structure of control').

The accepted audit methodology must ensure that IA will notify the management of any significant weaknesses of control and other discoveries and provide a correct, constructive advice regarding the improvement of control and resolution of certain problems.

Systems audit has 4 stages that we will analyse one by one:

1. **Audit planning** – the objectives of this stage are to guarantee that the tasks are correctly understood and organised, and to channel the audit resources so that the best performance is achieved in fulfilment of the audit objectives;
2. **Evaluation of the test and the results** comprising 3 important sub-stages:

– *development of the internal audit programme* – clarify and document the system, i.e., to guarantee that the system is sufficiently familiar, understood, correctly documented; to approve the audit scope and area of activity as well as to establish the primary opinion regarding the overall adequacy of ICS; to identify the most important areas for further analysis and testing of the system in practice; develop the audit programme;

- *tests* – obtain evidence regarding the application of control (compliance testing); obtain evidence on effectiveness of control (substantive testing) –

study the effect and extent of control weakness or system failure and to confirm the primary opinion on adequacy of control.

- *assessment* – to guarantee gaining of sufficient, important, reliable evidence; consider the role and importance of audit findings; establish judgements; consider the possibilities and formulate recommendations; to identify subsequent actions.

3. **Preparation of the audit report** – reporting the results and further activities: inform the appropriate parties on the findings and opinions; influence future operations; to oversee the responses; obtain desired results.
4. **Audit closure**.

These stages overlap and the process is repeated and is not linear (i.e., the auditor will have to move backward and forward, to justify the judgement, obtain further information or anything else). It should be pointed out that the so-called stages should not be considered as an absolute and unchangeable approach. We can find a varying number of audit stages in different audit-related regulatory documents, in different scientific papers as well as in the documents used by specific audit services, but in substance it is a more or less detailed division of one and the same process. So, for example, by Order No. 12019 of the LR Ministry of Finance of 29th December 2003 'Internal Audit Manual' that was binding for the employees of the public sector internal audit service, which presently has lost its effect due to being replaced by the CM Regulations 'Methodology of Internal Audit', 6 audit stages were named, but their wording and content, however, is slightly different (see Figure 3.1). At the same time in the IA service of the Rural Support Service 4 stages are recognised: planning, testing and evaluation, reporting and closure of the case. A similar approach is used also by *V. D. Andrejevs*. 4 audit stages are mentioned also in the new CM IA methodology. However, it must be noted that the content includes the same activities that were arranged in 6 stages – only the 3 middle stages are combined. Let us consider the more detailed breakdown to obtain full clarity regarding the range of activities to be performed and the methods to be used in the audit process.

3.3. Description of the stages of auditing

3.3.1. Audit planning

Planning refers to the understanding, predicting, timing, instructing and organisation regarding the audit objectives. During this stage all effort must be made to gain assurance that the scarce resources allocated for the performance of audit will be used in the best possible way. This means that it would be necessary to set priorities for the sectors to be audited and to predict any problems. Planning means taking the necessary steps to ensure that the audit objectives are fulfilled most efficiently and in conformity with the standards.

In the process of planning the IA strategic plan must be developed first after the identification of the scope of audit work. This plan defines the audit scope for 3 – 5 years. Strategic audit plan is designed by the IA unit manager and it includes:

1) all systems to be audited arranged in a prioritised order in accordance with the risk assessment;
2) the frequency of auditing each system;
3) resources required for the internal audit department.

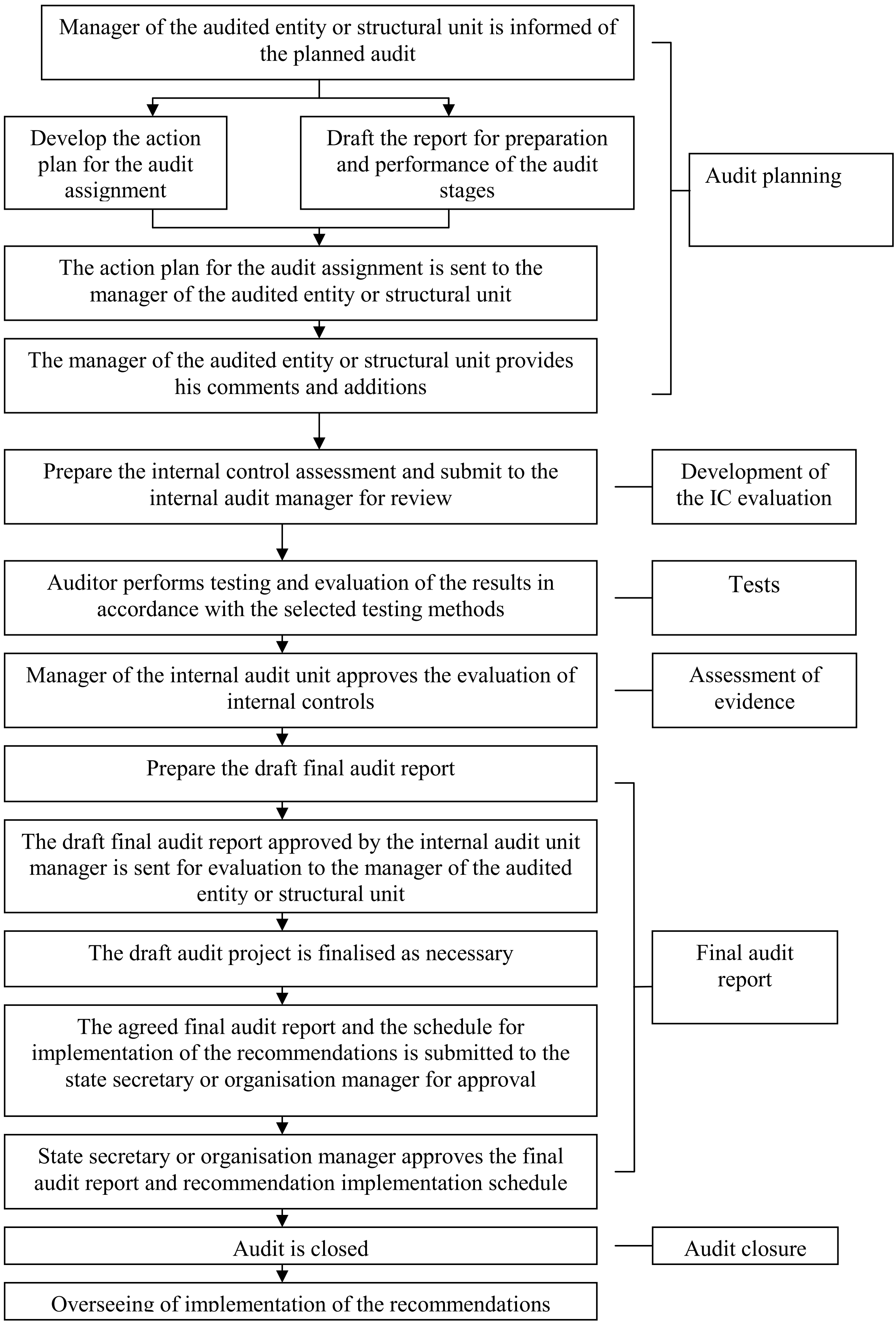
Manager of the audited entity or structural unit is informed of the planned audit
Develop the action plan for the audit assignment
Draft the report for preparation and performance of the audit stages
The action plan for the audit assignment is sent to the manager of the audited entity or structural unit
The manager of the audited entity or structural unit provides his comments and additions
Audit planning
Prepare the internal control assessment and submit to the internal audit manager for review
Development of the IC evaluation
Auditor performs testing and evaluation of the results in accordance with the selected testing methods
Tests
Manager of the internal audit unit approves the evaluation of internal controls
Assessment of evidence
Prepare the draft final audit report
The draft final audit report approved by the internal audit unit manager is sent for evaluation to the manager of the audited entity or structural unit
The draft audit project is finalised as necessary
The agreed final audit report and the schedule for implementation of the recommendations is submitted to the state secretary or organisation manager for approval
State secretary or organisation manager approves the final audit report and recommendation implementation schedule
Final audit report
Audit is closed
Audit closure
Overseeing of implementation of the recommendations

Figure 3.1 **Audit stages**

The strategic audit plan is updated each year by taking the audit performance results, the establishment of new systems and other factors affecting the existing systems into account. Development of the strategic audit plan includes the following steps:

- determination and updating of the IA environment;
- assessment of the systems risk included in the IA environment;
- identification of the priority systems subject to the risk assessment;
- establishment of the IA strategy;
- identification of the frequency of auditing;
- approval of the required and existing resources;
- development and approval of the strategic plan.

First, within the framework of the strategic plan development the assessment of risk level of each audited system must be performed. Frequency and sequence or priorities of auditing depend on this assessment. Risk assessment for each identified system must be done by assessing the following factors affecting the system operation:

1) control environment;
2) changes or restructuring;
3) level of complexity of the system;
4) connection with other systems;
5) cost level;
6) external impact;
7) time elapsed since the last audit;
8) concerns or doubts of the manager about the operation of the system;
9) possibility of financial fraud;
10) influence on further operations of the ministry or entity;
11) employee experience and qualification;
12) public interest.

Risk assessment for each of the factors must be performed by assigning points from 1 – 3 for all factors with the exception of factor 7 ‘Time elapsed since the last audit’ ensuring a five-degree grading starting from ‘less than a year’ and ending with ‘above 5 years’. Low risk is scored at ‘1’, while high risk – at ‘3’. Initially the IA structural unit manager determines the impact of each risk factor in the specific system by assigning a ‘scoring coefficient’ and then multiplying the risk assessment of each factor in points by the percentage of this factor, while the risk assessment of the system is found by adding the product results for all factors (see Example in Table 3.1). Table 3.1

Risk factors and their assessment

No	*Risk factor*	*Grading of risk factors*	*Scoring coefficient*	*Min and max points available*
1	*2*	*3*	*4*	*5*
1.	Control environment	1 -3	5	5 - 15
2.	Changes or restructuring	1 -3	4	4 -12
3.	Level of complexity of the system	1 -3	4	4 -12
4.	Connection with other systems	1 -3	3	3 – 9
5.	Cost level	1 -3	6	6 – 18
6.	External impact	1 -3	2	2 – 6
7.	Time elapsed since the last audit	1 -5	2	2 -10
8.	Concerns or doubts of the manager about the operation of the system	1 -3	3	3 – 9
9.	Possibility of financial fraud	1 -3	4	4 -12
10.	Influence on further operations of the ministry or entity	1 -3	3	3 – 9
11.	Employee experience and qualification	1 -3	3	3 – 9
12	Public interest	1 -3	4	4 - 12
				5)=(3)x(4)
Possible minimum number of points – 43 ***Possible maximum number of points – 133***				

Systems with a high degree of risk should be audited no less than once in 3 years, with medium degree – no less than once every 4 years, and a low degree – 5 years. When performing audit for the first time it should be taken into account that a study of the system is required and more time would be needed. A large audit is an audit which takes above 35 days, average – up to 35 days, and a small audit – up to 20 business days.

When planning the necessary resources the respective number of days is multiplied with the number of large, medium and small audits for all systems. In the result the number of days is obtained for performance of all audits (see Table 3.2).

Table 3.2

Assessment of resources required for audit (in business days)

No	*System*	*Audit scope*		
		Large	*Medium*	*Small*
1.	Common administration and management			
2.	Financial management			
3.	Human resources management			
4.	Provision of operations			
5.	Document flow			
6.	Information technologies			
7.	Public procurement			
8.	EU financed programmes and project implementation systems			
9.	Ministry or institution specific systems			
	Total number of audits*:*			
	Audit days	> 35	< 35	< 20
	Total number of days necessary for a period of three to five years*:*			

The required amount of days, however, for auditing of all systems must be consistent with the amount of resources available. It is estimated depending on the number of employees in the audit unit by assessing the number of working days available for the performance of audit:

Total number of auditor workdays = number of days per year – red calendar days-holidays-regular vacation days – auditor training days-disability days – unexpected works (min 10%).

It must be taken into account that the unit manager and his deputy on auditing only participate for a part of his working hours and therefore only a certain amount of days will be included in the total amount of audit personnel resources. For example, if an audit department has a manager, a deputy and 5 auditors, then the human resources available for auditing are as follows:

- manager – 15 days
- deputy – 100 days
- 5 auditors – 5 x 240 = 1200

Total: 1315 days

Apart from the strategic plan also the annual plan is being prepared which is an updated content of the strategic plan for one year. Any changes that have been made known after the approval of the strategic plan as well as other factors (for example, management requests) are taken into consideration here. In accordance with the annual plan the planning work for the performance of a specific audit is carried out. A team of auditors is appointed for the specific audit of no less than 2 persons, one of which is the auditor in charge.

By appointing specific auditors for the performance of an audit the following factors are being taken into consideration:

- knowledge, skills and experience necessary for the audit to be performed;
- the time planned for the audit;
- specifics of the audited system;
- objectivity and any possible conflicts of interest of the auditor;
- other important considerations.

The auditor develops the audit working plan which is an informative document and which is approved by the unit manager. Three final products are possible in the planning process:

a) planning memorandum (summary), which must be brief, and in general lines the objectives, priorities, the reason, main systems and facts, the client as well as any factors to be taken into account must be described;

b) administrative schedule – the procedural information about the distribution of responsibilities for the personnel, examination and management, reporting, arrangements, timing and budget;

c) audit programme or work plan – a more detailed document containing technical instructions and comprising all stages of audit, the risk and critical control issues as well as any other important issues to be taken into consideration.

Below a detailed outline of the specific audit planning is given.

The audit planning phases are as follows:

- to prepare a draft audit plan based on the existing knowledge and already approved cases (for example, timing and broader objectives), discuss it with the team-mates and adopt internally;
- discuss the project plan with the stakeholders (the client);
- adjust the plan after discussions and obtaining of further information;

- obtain the necessary approvals;
- notify the audit related groups;
- implement the plan;
- compare the actual progress with the plan;
- adjust the plan if necessary (a more detailed control and risk evaluation, audit findings, uncontrolled deviations from the plan).

Review and analysis of preliminary information

In order to assess more precisely the audit scope and objectives, after preparing the audit work plan the auditor reads all available information regarding the audited system:

- regulatory acts containing information about the audited system;
- materials collected in permanent files about the audited system;
- previous audit working papers and audit reports regarding the audited system;
- recommendations provided in the result of the previous audit and the results of their implementation;
- any available conclusions or reports made by external auditors regarding the audited system;
- information from all related structural units and other entities;
- any other type of information that may give a view of the audited system.

Introductory interview of the persons audited

For finalisation of the information, if necessary, the auditor may interview the employees of the audited unit and clarify the audit objective, and agree on the course of auditing. During the interview an auditor can find out what the entity expects from the audit.

Planning the assignment performance

Auditor plans its audit assignment and prepares the audit assignment plan (Appendix LAD). When establishing the objectives of the assignment, the auditor considers the probability of material errors, inconsistencies, inaccuracies and other problems.

Upon planning the assignment auditors must take the following conditions into account:

1) objectives and means of the audited unit for controlling the operations;
2) material risks regarding the structural unit, its objectives, financing and operations as well as the means with which the risk exposure is maintained at an acceptable level;
3) adequacy of the structural unit risk and control system and its efficiency compared to a proper control model or structure;

4) possibilities to considerably improve the unit risk management and control system.

In the work plan of the IA assignment the auditor must include the following information:

1) audit title, including the title of the audited system;
2) audit reference No;
3) the number of days planned for the audit;
4) expected date of the draft report preparation;
5) name and signature of the auditor;
6) name and signature of the IA structural unit manager;
7) system objectives determining the need for such a system and helping to identify the possible operation risks that need attention;
8) control objectives of the system defined by the management, the task of which is to ensure the fulfilment of the system objectives;
9) audit objective;
10) comments.

Prior to the commencement of the audit the auditor must discuss the audit assignment plan with the persons audited by finalising the objective of the audit, agreeing on the course of the audit, the contents and form of the report, the procedure for discussing of the audit findings. The audit assignment plan must give a sufficient notion to the audited persons about what activities will be undertaken during the audit and to what documents the access must be provided.

Letter on commencement of audit

At least 10 days prior to the expected audit start a letter on commencement of audit together with the audit assignment plan is sent to the unit manager. If there is some specific information required for the audit performance the auditor must specify it in the letter. Auditor may request the provision of information also by the audited person by sending different tables to be completed by the audited person.

After the planning work is over an overview of the preparation and completion of the IA stages is also prepared (partially).

3.3.2. Evaluation of the test and the results

Development of the internal audit programme

Pursuant to the objective specified in the audit assignment plan the auditor specifies the audit scope and completes the internal control evaluation in the form **IA programme**.

For every control objective the auditor identifies the probable risk factors as well as those controls that would impede or eliminate the effect of such risk. Auditors also take into account the risk factors and identify those risks that could prevent the fulfilment of the control objective. Upon commencement of audit the auditor identifies the existing controls and establishes what controls are necessary for prevention of the risk.

The preliminary assessment of ICS includes the following steps:

1. System identification.
2. System evaluation (including the identification and assessment of risks).
3. Development of the audit programme.

(1) **- System identification** Upon carrying out the audit assignments the auditor must identify, understand and record the audited system, approve the accuracy and completeness of his records and understanding. Prior to the commencement of the work the (audited) system must be defined. This includes also the recording of its structure and assessment of the means needed and used for the fulfilment of its objectives (functions). Likewise the system processes and sub-processes must be identified along with all activities, final products as well as the limitations and external connections of the system. It is quite difficult to separate or 'isolate' one system from another, but it is still necessary to focus on the specific audited activity. Systems can be financial or operational, they may be dependent on a computerised information processing, they may be formal or informal, they may be both a project and a continuing activity. Auditors must know how the system is defined: as it was formally intended or as it operates in reality. By identifying a system it is recommended to prepare the 'System fact sheet' where the auditor records organisational and management activities, policies, obligations, authorisations, main facts, the required basic information, most important areas and issues of interest, main procedures and processes.

In the search for facts the main attention is devoted to *interviewing*. This method provides for obtaining the results by creating the right atmosphere through:

- establishment of connections;
- effective questioning;
- effective listening;
- evaluation of answers;
- effective recording of notes;
- use of non-verbal communication;
- preparing a summary.

Interviews have several stages:

- preparation – deciding on whom to meet and when, set the objective, approach, predict the questions – 'a homework';
- commencement of an interview - creation of the right atmosphere;
- guidance of the interview – asking the right questions in an appropriate manner, forming a discussion, noting, interpretation and recording of the answers, the corresponding reaction;
- completion of the interview – the best timing for completion is at the moment when the objectives are met;
- additional activities – analysis of the information obtained, recording of interviews, searching for confirmations, further interviews.

Recording of the system can be done in different ways, but one of the most appropriate is the development of flowcharts. Flowcharts represent a system in a highly visual form; they precisely illustrate the flow of employee responsibilities, documents and information. Flowcharts are used for two reasons: a) for the recording of a system; b) to assist the auditor to make the preliminary evaluation the internal control system.

They have limitations, however, there are no standard techniques or sets of symbols, sometimes they make the whole process even more complicated; flowcharts are suitable for data processing systems as they illustrate the movement of documents and information, but do not reveal all control forms that are used; the preparation process is too long; some systems do without any paperwork – all data are input, processed, stored and transferred electronically.

Some organisations have developed their own symbols ***for preparing of flowcharts***. The view of the auditor on the operation of a system is to be approved by special tests that are not intended for examination of controls and transactions, but for approving the completeness and accuracy of understanding. For this purpose the samples of the main transactions are taken and they are followed through in the system from the beginning to the end to ensure if the auditor has identified and recorded all important levels and processes – including exceptions and alternative sequence of events.

(2) **– System evaluation** It is the obligation of the auditor to provide an independent opinion of the adequacy and satisfactory operation of management control. Therefore the auditor is interested in giving an opinion regarding both the individual controls design and their implementation in practice and the control system as a whole to be able to alert

the management regarding the serious weaknesses in control and to give advice wherever it is needed. The purpose of this audit stage is:

– assess the structure of control;
– identify the specific controls implemented by the management;
– examine the interrelation of these controls with system objectives and risks;
– create the preliminary opinion about the adequacy of control;
– in the result of primary evaluation define the strong, satisfactory and weak areas and consider the level of risk;
– based on this information the future areas of auditing should be identified, including testing.

When monitoring the system the 6 principal questions to be asked from the systems audit should be recalled:

1. Do any controls exist?
2. Are the existing controls effective and adequate?
3. Are the controls consistent with the design – are they secure and complete?
4. Have the controls been implemented?
5. Do the controls meet the requirements?
6. Are the controls efficient in practice?

There are 9 steps in internal control assessment:

<u>Step 1</u> – Approve the objectives, criteria of success, **control objectives** of the main system (for the system as a whole and individually for each level). Are the control objectives defined, reachable, accepted, effective and understandable? Are there any conflicting objectives?

<u>Step 2</u> – **Risk** identification and assessment (can be assessed by to the above techniques). There should be a segregation of the operational risk that has two dimensions: inherent and detection risk, control risk and audit risk.

<u>Step 3</u> – Define attitude towards control and set standards – **the control environment**. Consider what controls the auditor intends to find: not an ideal system, but a suitable control structure and specific control mechanisms designed to meet the needs of situation.

<u>Step 4</u> – Identify the real **control mechanisms**, particularly the primary and critical controls. Do they make an integrated internal control system? Are they targeted at special control objectives and risk? Separate the controls from the process.

Step 5 – **Compare** the implemented controls with the control objectives, risk, best practice, and best quality control. It is important to see who decides what is required?

Step 6 – **Evaluate the adequacy of the existing controls**: identify the inconsistencies with the best practice and the expected standards of control. Identify strengths and weaknesses, and assess the level of the unknown risk. Assess whether the control is not too big and unnecessarily complicated?

Step 7 – Take into account **the significance of any deficiencies found**. Assess the effect, consequences and causes of any weaknesses: seek an explanation and define the responsibilities of the employees. Examine what are the 'uncontrollable' components.

Step 8 – Create the opinion on the adequacy of control, i.e., the professional, objective, informed judgement of the auditor regarding the level of assurance provided by the individual controls and the potential level of confidence in the completeness of the control system as a whole. Does it cope with the risk at present? **Is it realistic in regard to the future that does not promise anything good?** Create an opinion on the real cause and inadequacy as well as clarify whether the management agrees to that.

Step 9 – Decide on the next step that could be a report to the appropriate management level or carry on with further studies identifying the areas to be tested.

In the system evaluation activity auditors can employ different techniques. These are as follows:

- *internal control enquiries* which are series of logically arranged questions and are specially designed to assist the auditor to identify the controls and to assess the adequacy of operation of the general internal control system;
- *risk-based enquiries* If the answer to an internal control enquiry question is 'no', it proves that there are control inefficiencies. As this enquiry asks questions about risk, the answer 'yes' indicates the possible weaknesses.
- *Internal control evaluation sheets* (This sheet is also provided for in the methodology prepared by CM). This technique does not contain questions, but 2 sections of a form in which the following is explained in detail: a) scope of audit work in respect of the risks identified and assessed; b) internal control assessment made after the evidence gained in the audit;
- *Recording of the weak areas of control* – a document in which all the weaknesses of control are summarised and their causes, the effects incurred, any measures proposed/performed by the audit, any measures

proposed/performed by the management, other observations, references to the relevant documents are indicated;

- *Risk analysis* To var raksturot kā darbībai radīto potenciālo zaudējumu vai kaitējumu sfēras, avotu, apjoma un cēloņu noskaidrojums.

(3) - **Development of the audit programme** This programme includes the methods of testing, the questions to be included in the checklists and the scope of testing for controls selected for testing. In the audit programme the auditor must as accurately as possible describe the testing methods selected and the process of their execution. The audit programme is presented in Column 4 of the form **Internal Audit Programme** where next to each risk the necessary control and the assessment of the actual control, and the testing to be done given. For each control identified the testing method is determined.

Testing

During the next stage of auditing a systematic testing is carried out which is based on the results for the previous risk and control evaluation. The objectives of the tests are as follows:

- purposefully and selectively test the application of control and its efficiency in practice;
- to confirm the auditors preliminary opinion regarding control;
- study known or identified weak areas.

The aim is to collect further evidence to be able to establish a balanced judgement about the internal control system as a whole regarding both the design and the operation. Now the task is to discover whether the controls that the management relied on operate correctly and efficiently. Is there any possibility that they will likewise operate in the future? Special tests require special tasks. Evidence may be required in order to convince the management of the need to improve the controls that have been incorrectly designed. It is not the duty of audit to form an opinion concerning performance – should it be committed to accounting, efficiency of operation, existence of values or anything else; and neither should it act in the authority of internal control. The duty of auditors is to give an independent assurance of the adequacy of operation designed by the management to make sure whether accounting is reliable, whether the activities are performed skilfully, the values protected, and fraud prevented. It is not the duty of an auditor to seek for errors in financial statements, i.e., the objectives of control may not be mixed with the audit objectives. Indirectly auditors may use the cases of error to provide evidence.

The testing stage has seven steps:

1) to determine the testing strategy;
2) prepare the testing plan (it can be also included in the audit programme) or to correct and supplement the existing plan;
3) to carry out the tests;
4) to interpret the results;
5) wherever necessary perform further testing;
6) evaluate the findings;
7) to identify the next steps for audit and management.

Obtaining the evidence

In the result of testing auditors must obtain **relevant, reliable** and **sufficient** evidence that any reasonable judgement and recommendations could be based on. Evidence can be obtained by using the following methods:

- interviews;
- observing;
- review of documents;
- parallel testing of controls;
- analytical testing (data reconciliation) is a detailed transactions testing (inspection, external confirmation, parallel tests);
- use of mathematical models;
- acquisition of an independent confirmation;
- confirmation by facts;
- reconciliation;
- obtaining the opinion of an expert;
- checking of published reports/investigations;
- enquiries;
- comparison;
- enquiry of user/service customer satisfaction.

Depending on the type of audit appropriate methods of testing are selected. Usually, when performing an audit, auditors use several of the above mentioned methods.

There are different techniques available for the performance of tests, for example:

- confirmation – the use of justifying evidence (original documents) in order to assess the stage of completeness, accuracy, effectiveness or other criteria for the transactions as well as the confirmation of responses and facts by reference to other preferably external evidence;

- inspection – obtaining or giving of evidence (accuracy of records or existence of the values);
- comparison with, for example, benchmarks, other transactions, previous years, experience gained elsewhere;
- reconciliation – typically of a group of figures to another, items to values.

The sources for obtaining of evidence are the management, personnel, third parties, other auditors, the auditor carrying out the testing.

The types of tests used in this audit stage are as follows:

1) compliance testing;
2) substantive testing.

Compliance testing is testing when audit evidence is sought to the fact that the internal control procedures are applied in compliance with the procedure descriptions, instructions and regulatory acts. Two levels are distinguished here:

a) preliminary testing where it is established whether the pre-set procedures have been followed;
b) further testing with the help of which the level of materiality and the effect of inconsistency is assessed, for example, it is examined whether the invoices are approved prior to payment and how often it takes place. Whether any cases have been detected when payments are made without approval, how many, and why?

By the end of compliance testing auditors would have made a conclusion on what is:

- the scope of compliance (the time period for which the compliance must be consistent);
- the nature of inconsistency (in a certain area, certain period, constant, irregular or occasional, incidental or intentional);
- significance of inconsistency;
- the causes (ignorance, intentional intervention or fraud, error, adoption of 'better' procedures, effect of the circumstances etc.);
- the effect (the probability of errors, losses etc. increases);
- further actions to be performed by the audit (further compliance tests or substantive tests) and the management.

For the auditor the link between control and inconsistency is particularly important. Could this inconsistency take place due to the failure of management to take measures?

Why was it left to the auditor to reveal the inconsistency? [Compliance testing may not be mistaken for *the compliance audit* where the audit scope is segregated from the assessment of compliance controls].

Substantive testing is the testing where the transactions and the final results are examined and which gives the audit the evidence that the control procedures are effective in practice. This would mean that the objectives of control are met. The natural order for performance of tests is as follows:

1. assessment of internal control;
2. compliance testing;
3. substantive testing.

If the critical weaknesses are discovered or if any suspicion arises about them during the evaluation of internal controls, auditors will usually perform substantive tests. If the controls turn out to be reliable compliance testing can be performed. If there are small inconsistencies, the auditor may perform extensive substantive testing in order to assess whether an error or a loss has occurred. If the procedures are followed, a limited amount of substantive testing will be carried out (it is logical that in case when only a few substantive tests will be performed there is no assurance that the results of the system perception would be as they actually are, for example, that the controls will be effective in practice if the controls are well designed and the procedures are followed.)

There is an opinion that substantive tests are having only a limited significance. It should be underlined in particular that substantive tests should not be performed if the weaknesses of the control system are obvious. Rather the management should be informed and it should further resolve the issue.

Substantive tests for transactions are defined according to the following:

- the results of control evaluation;
- the results of compliance testing;
- judgement about the risk and its significance;
- the necessity to perform the collection of further evidence;
- known problems;
- the necessity to carry out special studies in certain areas;
- the decision to perform selective controls of the transactions independent of the controls.

During substantive testing the auditor is interested in the issues of 'substance' and therefore examines the transactions and their characteristics; the final product of the system; effectiveness of internal control; the fulfilment of control objectives; risk prevention; how often the deviations from standard have been found; what is the amount and effect of 'deficiencies and circumstances of error'. The scope of substantive testing includes the achievements (whether the goals have been met, reached or whether the criteria for success are complied with); compliance with the laws, policies, practice; regularity of transactions; reliability of information and transactions; efficiency of operations and economy of the resources consumed; the security of values and interests. Therefore, the scope of substantive testing is broader than the range of tests performed by external auditors, where the primary interest is confidence in accounting and the published financial statements.

Tests may be carried out in a selective form by testing a part of the population of business transactions or events and projecting the results to the entire population. The decision on application of selective testing is connected with the efficiency of use of the audit resources (costs) and the audit objectives:

a) if the population tested is small there is no need to make the selection;
b) if the audit evidence needs to be by 100% reliable, for example, in the case of a fraud, selective testing cannot be used;
c) it is not possible to make a selection that would give a view about the entire population audited;
d) the audit population consists of incomparable elements;
e) in other cases when it is more useful to perform testing of 100% of items.

An audit sample is an amount of transactions selected from an audit population or determined by controls for the performance of tests or detailed tests. The selection can be made by using the following sampling methods:

1) non-statistical – the method based on a judgemental opinion. It is based on risk-assessment, for example, by selecting the largest amounts, the most risky transactions. Samples can be selected by order number or by the random selection principle.
2) statistical method (see Figure 3.1). According to the statistical sampling method the selection of data samples are performed on the basis of the probability theory. This method is usually applied when testing a population consisting of a large quantity of homogenous data. The statistical method allows choose the minimum sample selection size required for the fulfilment of the audit objective by

obtaining accurate, reliable results. The statistical method is used in cases when it is required to express the results of sampling in quantitative measures.

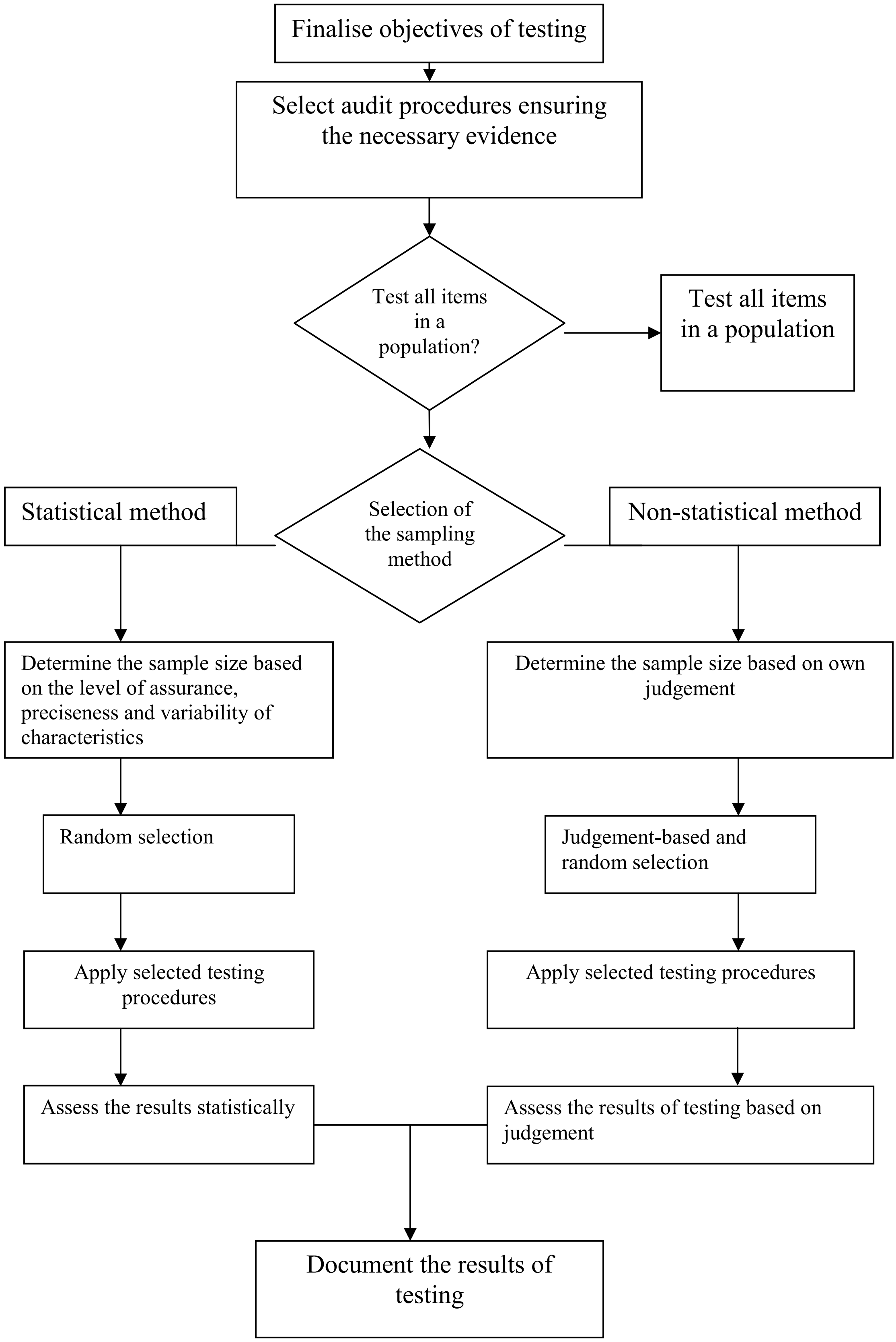

Figure 3.2 ***Sampling methods***

Based on the above risk assessment the auditor performs sampling and evaluates the result in the following procedure:

- identifies the standard applicable to the testing sample (laws, other legislative acts, instructions);
- determines the tolerable error which is not considered to be material for drawing of any conclusions regarding the entire population;
- determines the size of the error or deviation at which the sample will be extended and in what extent;
- chooses the method of sampling;
- performs the sampling;
- performs the testing of selected samples;
- if necessary, extends the size of the sample;
- evaluates the results and documents the conclusions.

Evaluation

The results of audit tests, answers to the questions and other findings must be carefully evaluated. During this stage the auditor:

- reassesses the importance, reliability and amount of the evidence;
- interprets its meaning and assesses its significance;
- puts together several items of evidence to obtain further information and better view regarding the situation;
- considers the recommendations for improvement;
- ensures that the evidence and the working papers constitute a sufficient basis for presentation to the management.

Often insufficient attention is devoted to this stage. Often in the works of many authors this audit stage is not even listed. However, the reason for this certain negligence can be different: the auditor is short of enthusiasm; time; he is in a hurry to finish the assignment. He fails to approve, give consultation, think, arrange the documents. There are two main aspects of this stage:

a) consider the significance of the individual findings;
b) form an opinion on the system as a whole – about its design and operation.

Auditor must confirm the quality of the collected evidence and consultations. The facts must be verified if they contradict the views, generalisations and assumptions. The sources of evidence must be clearly documented. The auditor documents the information gained in the audit process in order to justify the audit objectives set, the results obtained and conclusions made in the audit process. Audit evidence must be appropriately and clearly outlined in order for the auditor to be able to evaluate it and to draw conclusions based on the analysis made. Audit evidence can be processed in the form of:

- questionnaires;
- tables;
- diagrams;
- flowcharts;
- in free text;
- minutes of negotiations;
- overviews;
- checklists;
- documentation of evidence and performance of analysis on the basis of a copy of the document obtained;
- in any other form of documentation acceptable in the given situation.

The auditor chooses the most appropriate types of audit evidence documentation for each audit, so that the process can be overseen, but covering all of the above mentioned types as far as possible. Wherever possible the results must be summed.

The audit findings must be explained and the results must be sorted, reviewed and analysed: the confirmation for further inspection must be obtained by interconnecting different pieces of information, for example, such that may seem to unrelated from the first sight. Well prepared documents make this task easier. Wherever necessary, another view must be obtained by sometimes consulting with the specialists.

When analysing the results the auditor must identify the seven elements of the 'search for deficiencies':

1) identify the standard by which the practice or performance is evaluated;
2) observation of the actual practice;
3) identification of differences between the two previous items;
4) evaluation of the effects of the discrepancies;
5) identify the cause of the differences;
6) identify the significance of the effect of discrepancies;
7) understand what should be done and who should do it.

The finding can be significant by itself – material error, serious inaccuracies, potential savings etc. Auditor will recommend the correction of such deficiencies or assess the possibilities of making the necessary improvements. It should be remembered, however, that an individual case by itself may be insignificant, but the error found can be often recurring and indicate the lack of control. The possible causes of the deficiencies or unused opportunities can be as follows:

- external factors;
- other impacts;
- intentional fraud;
- failure in management control.

An auditor in his work cannot focus on the deficiencies as then the general picture can be distorted and a wrong perception established. Auditor must be: interested in respect of the possibilities, not the shortages; identify strengths and weaknesses; shortages must be viewed in context with everything else; the sense of proportionality must be maintained in respect of the good and the bad; focus must be laid on material and relevant findings.

In the result of evidence evaluation the auditor must decide whether:

- further testing should be done;
- make references to other auditors (specialists, auditors of similar areas of activity, audit management);
- seek advice from other specialists;
- submit the findings to the management.

At this stage determination and persistence may be needed, particularly if others would prefer that the person doing further examination of the issue is not an auditor! Any action depends on the discoveries made, for example, suspicion of any irregularities or fraud could require the auditor to practice caution and follow certain procedures with great attention and diligence.

Conclusions on the transactions, controls, system and its management must be valid, logically reliable, based on evidence that can be demonstrated, and should be accepted by everybody involved.

During this stage the auditor forms his opinion of the system – his professional judgement regarding the measures established by the management for the achievement of specific objectives, compliance, application and efficiency. This opinion will substantiate the demonstration of the potential risks, illustration of any failures and its evidence, illustration of any success and its evidence as well as other issues to which the auditor wants to pay the attention of the management.

The content of the decision adopted by the auditor refers to system planning – by identifying the compliance of internal control (strong, maybe even too much, adequate, inadequate) and the system operation – the application and efficiency of controls. Conclusions will apply to the objectives of the main controls; the main stages of the system (critical control and specific control objectives at each stage); the main types of controls (management, organisational, financial etc.) and the general control management and achievement of the system objectives.

The form of the recommendations may be both as a choice offered, specific suggestions or solutions. Auditor cannot excessively engage in the development, planning and implementation of any solutions or new systems, however, he must respond to the requirements and expectations of the management, seriously evaluate the need to be constructive – maintain independence and objectivity. Any recommendations must arise from the conclusions adopted and they should be valid, welcome, realisable, cost-effective and discussed with the respective management levels. Therefore, the auditor now being equipped with a clear and supportable opinion regarding the system and using sorted and carefully arranged working papers containing reliable evidence, that has been reviewed by the audit management, can start preparing his report.

3.3. 3. Preparation of the audit report

The purpose of the auditor's report is to communicate in a written form the audited structural unit any inconsistencies found and to provide the possibility to the manager of the audited unit to comment on the findings of the auditor. Audit reports must be precise, objective, understandable, constructive, complete and timely.

The practice shows that the reports are the cause of the majority of problems and dissatisfaction. It is often said that the auditor's report is the 'audit signboard'. In some cases the report is the only way for the management to see the audit work, while in all cases the management should use the report as an instrument in decision-making.

Before we discuss the contents and the preparation process of the audit report in detail, it should be admitted that there are several audit report categories:

1. functional progress and performance reports intended for the person in charge for the internal audit quality (annual report to audit committee);
2. administrative report for the person or organisation in charge of regular control (budget reporting to the finance director);

3. report on the audit assignment to the client on audit conclusion.

The two following aspects must be taken into account when reporting:

a) reporting procedures;
b) report writing.

The purpose of reporting, the expected response of the report addressee and the information to be provided for ensuring of the response is summarised in Table 3.3.

Table 3.3

Connection of the report objectives with the content

Objective	Response of the addressee	Information provided
Communicate	Understanding	Circumstances (facts)
Warn	Awareness	Standard/results (criteria, comparison)
Convince	Consent	Effect, significance (consequences)
Obtain results	Action	Cause Recommendation (correction)

(a) – procedures of reporting Reporting as a set of activities can be rather complicated and therefore the differences of the procedures employed in reporting must be understood.

- Interim reporting may be used in cases when it is necessary that the management acts immediately for the prevention of any operational mistakes or where it is necessary to inform the management of the progress made.

Final report For each audit performed a draft final report is prepared communicating the facts found, conclusions made, recommendations and their implementation. The manager of the internal audit unit must ensure that the report is concise, direct and precise and the issues discussed there can be easily understood. The working copies of the report must be discussed and reviewed together with the respective managers and they should represent the decisions already made. In the final report any changes that are necessary and that have been agreed upon during the consultations must be taken into consideration, but any disagreement can also be represented.

- Distribution of the report Reports should not be distributed to everybody. They are confidential as the trust must be maintained. It should be decided at the beginning who are the persons that will receive the report. Usually there are two recipients:
  - the department manager who is responsible for the work at the operational level as he is the one who will implement the recommendations in real life;
  - senior manager having a strategic responsibility for the function and being in the capacity to ensure the realisation of the recommendations.

The report, however, will be received also by the specialised top executives, for example, the finance director as well as external auditors by exercising their rights. A certain part of the information may be inappropriate to disclose to all recipients. Some individuals may request several versions of the same document.

- Additional measures The obligations of internal audit do not end by writing the report. The organisational activities should be to ensure that the reports are understood correctly and that action will be taken as necessary. The final audit product should be the action plan.
- Behavioural aspects of reporting Reporting is not just associated to a procedure. Auditor must evaluate the need to create and maintain effective working relationships by establishing contacts, consulting and otherwise making the audited entity to participate. Reporting process is related to the likely response by the audited person to 'inspection', criticism, advice and recommended changes. Most acceptable tactics must be chosen in order to deal with these expressions.

(b) – report writing

When preparing a report a certain reporting format must be considered, i.e., the structure; writing should be done in an appropriate style; effective presentation and 'selling of the product' must be ensured – as the realisation of the recommendations must be achieved.

It is recommended to include the following sections in the final audit report:

- audit objective;
- audit scope;
- findings (both positive and negative);
- conclusions;
- areas where improvement is needed;
- recommendations.

In practice also other components may be included in the audit report, for example, the basic information on the system audited, the auditors involved in the audit, the time spent on auditing; significant changes made to the auditing plan and the programme in the course of audit; the audit method applied; audit population and sample size (LAD) etc. subject to the circumstances. The internal audit experts at CATS International believe that the report format could consist of 5 sections:

1. Audit letter/memorandum – can be a 1 page resume on the audit performed, summarising the findings and giving the audit opinion.
2. Section A of the report:
   - Cover, content, page – headings, names of the auditors, period audited, addressees, report date;
   - Introduction – report objectives, audit objective and scope;
   - Basic information – system description, concentrated figures and facts, responsibilities and authorisations;
   - Audit procedures – approach, scope of work, issues omitted, actions taken since the last recommendations;
   - Summary – main findings, conclusions, audit opinion.
3. Section B of the report:
   - Findings – issues that have arisen and have been assessed, area by area, conditions/criteria/comparison, effect/ meaning, cause;
   - Conclusions – the good and bad conclusions related to the system objectives, diagnosis;
   - Recommendations – long-term and short-term assets for correction of 'shortages' and improvement of control.
4. Section C of the report:
   - Actions undertaken – management comments and response, action plan (actions approved and performed; actions approved but not yet performed; disagreements; areas for further research, coordination of further steps);
   - Audit opinion – general conclusions; the perspective and forecast; approval.
5. Appendices – important reference material to substantiate and explain comments and findings.

Presentation of the report also plays an important role in this audit stage – the way the text is composed and presented. Text organisation and balancing of is important. There should be more evaluation than description. The report cannot be a story of auditing. An effective presentation requires the following:

1) analysis – breakdown of the findings into 4-6 main groups with sub-levels; one sentence describing the general situation;
2) grouping – review and sorting of findings;
3) order – the results may be presented in the following sequence: events; system levels, functions, significance, system/control objectives, main types of control, reliability, acceptability;
4) benefits – whether the addressee will be able to understand;
5) flexibility – there is not a correct structural format – sometimes it is recommended to leave the general opinion to the end;
6) skill – not all of the audit results or management activities should be clearly identified: often conclusions and recommendations will be an indirect finding, but the message should be clear.

The set of techniques to be used in the presentation is as follows:

- start from the end – with the conclusions;
- include the most important issues first;
- to be straight, but tactical;
- to demonstrate interest in the current interests of management;
- include only the information that is reliable, relevant and sufficient for the formation of auditor's opinion;
- corrections must be such that eliminate the difficulties instead of complicating them;
- to identify the cause;
- to emphasise the effect and not the events – significance and causes;
- explain the recommended real activities related the causes;
- to emphasise the solutions and results instead of a detailed procedure; possibilities rather than shortages, systems rather than personalities.

Ensuring the fulfilment of the recommendations is a considerably difficult task as the management not always fulfils the recommendations. Auditor cannot force the manager to do it, but his duty is to submit proposals with such confidence that the management accepts them, to oversee whether they are correctly understood and to define the reasons for rejecting these proposals.

Thus, during this stage the following documents are prepared: **draft audit report; draft schedule for implementation of recommendations; the audit report** and **the schedule for implementation of recommendations**.

3.3.4. Audit closure

After the approval of the schedule of internal audit recommendations the auditor prepares the ***IA closure document*** and submits it for review to the structural unit manager. Before closure of the audit case the evaluation of the audit process is performed by comparing the planned course of audit as in the audit plan with the actual performance. Any significant differences are documented and the reasons are taken into account when carrying out further audits. The evaluation of the audit process is approved by the audit department manager or deputy manager. Audit case is closed after the evaluation of the audit process is done and the following information from the recommendations schedule is entered in the database: audit number, auditor in charge, inconsistencies found, level of risk, recommendations, comments of the audited person, implementation dates, responsible person, implementation status and auditor's comments. **The internal audit closure document** prepared by the auditor and reviewed by the internal audit department manager is included in the audit file in the 'Overview' section.

After the closure of the audit file the auditors must track the implementation of the recommendations issued by them, but the auditors are not responsible for the recommendation implementation process and their compliance with the approved implementation dates. The auditors may gain assurance about the implementation of the audit recommendations by requesting in writing the manager of the audited structural unit to submit the report on the implementation of the recommendations indicated in the report by attaching documental evidence proving that the recommendation has been introduced. The second option is to carry out the so-called 'post-audit'. The internal audit department manager after evaluating the significance of the problems found during the audit and the level of risk arising from them defines whether the 'post-audit' should be carried out and how.

The IA file is closed either after the implementation of the proposed recommendations or they are cancelled. ***The IA file closure document*** is then prepared.

3.4. Internal working documents and audit file

In order to ensure a good quality audit performance and to streamline the summarising and systematisation of the working papers accumulated during the audit process it is necessary to collect all audit working documents in one audit file. This is also necessary to allow any third parties to make sure about the audit process. Audit file includes all documents referring to the specific audit case, for example, the checklists, minutes of negotiations, summaries, schedules, action plans, periodicals, document copies and other documents providing any audit evidence.

Each working paper must necessarily contain the following requisite data:

- document number;
- the title, indicating for what purposes the document has been used;
- audit reference number;
- source of information used;
- from whom and when the document has been acquired if it is not made by the auditor himself;
- reference to the supporting document where any records made include conclusions about the audit evidence also in this particular document;
- references to other working papers;
- the initials of the auditor;
- description of the abbreviations used, except in cases when generally accepted symbols are used;
- date of the working paper;
- notes made by the reviewer;
- initials of the reviewer;
- date of reviewing.

The audit file fully represents the audit process from the moment of information collection and discussions with the relevant officials to the final audit report submitted to the manager. Summary of all documents in an audit file helps auditors to perform internal audit in accordance with common principles as well as ensures a proper representation of the facts disclosed in the final audit report. Archiving of files takes place in accordance with the statutory requirements (the terms and conditions approved by the Minutes of the General Directorate of the Latvian State Archive of 23rd December 2003 'On organisation of internal audit files for further storage and terms of storage of audit files').

In accordance with the CM Regulations the audit file has a certain structure. It opens with the background on each system audited, besides, for each system in a different file. It includes all materials collected about the audited system before the audit commencement. Before the commencement of the audit the auditor must ensure that the background information about the specific system is updated and, if necessary, performs the necessary measures for the updating of the information. It is required for the preparation of the audit assignment work plan.

The audit file has at least 5 sections:

1) Planning – includes all documents related to the planning process – the IA assignment work plan; identification and assessment of risks, preliminary assessment of internal controls, the audit programme;
2) **Tests and evaluation** – includes the evaluation of internal controls and the documents related to the performance of all the tests and evaluation processes – a completed form of internal control with a summary of the findings, references;
3) **Reports** – includes final audit report, any comments received, final report version and agreed schedule for implementation of the recommendations;
4) **Overview** – includes the statement of the audit process, notes made by the internal audit unit manger about the preparation of the separate audit stages and the work of auditors as well as the audit closure document;
5) **Procedure for implementation of recommendations** – includes information about the process of implementation of the audit recommendations, correspondence with the audited structural unit.

Each audit file is given its reference number by indicating the title of audit and the name of the auditor in charge. All working papers before inclusion in the corresponding audit file section must be numbered, for example, B32/5 where the letter indicates the title of the audit file section; the first digit indicates the order number of the document, the second digit indicates the pages of the respective document. The respective entry is made in the form **Documents included in the section**. This listing of documents at the beginning of a section provides information about the documents included therein. The documents are held in the audit file in a chronological order by date of receipt or drafting.

Checklist for Subject 3:

1. ***Compare the advantages and the drawbacks in cases when internal audit functions within an organisation are performed by an established internal audit service and when these services are raised from 'outside'?***
2. ***Describe the necessary arrangements and conditions for the establishment of internal audit units.***
3. ***Compare the concept of a systems-based audit to the specifics of operational and investigation audit. Provide the examples.***
4. ***What level and substance work plans are prepared to ensure the operations of the internal audit unit?***
5. ***Name the objectives for the development of the strategic plan and describe the methods or risk assessment.***
6. ***How is the amount of resources necessary and available for audit assessed? Explain the nature of the problem of inconsistency in the given values and further activities to be undertaken?***
7. ***How does the planning of a specific system audit takes place? What audit working papers are prepared in the result of planning?***
8. ***What is the content of the internal audit assignment work plan and the audit programme? Who prepares and approves them?***
9. ***What is the role of internal control system assessment in audit planning?***
10. ***Describe the most essential techniques used in the 2nd stage of the audit 'Evaluation of testing and the results'.***
11. ***What are the features characterising the evidence obtained in the result of testing for the evidence to be valid for making of auditor's conclusions and the development of recommendations?***
12. ***What methods need to be applied in audit sampling when making the selection? In what cases it is not necessary to carry out the testing on a sample?***
13. ***How are the testing results processed?***
14. ***Describe the objectives for preparing and presentation of internal audit report and the respective information to be included in the report.***
15. ***Explain to whom is the internal audit report submitted and whether its contents are confidential?***
16. ***What activities are related to the closure of audit?***

17. ***Mention the most important requirements to the establishment of the audit file and processing of the audit documents.***
18. ***Assess the significance of each internal audit stage for the improvement of the quality of audit work.***

3. For practical boosting of knowledge learned under Subject 3 the students are doing a **practical assignment** 'The preparation of working papers for auditing of the procurement system and a preliminary assessment of internal controls' – see the case analysis and the forms of working papers in the Appendix.

Subject 4

Standards for the professional practice of internal auditing

4.1. The general policy for development of the standards and latest changes

The standards for the professional practice of internal auditing were first approved in 1978 by the International Auditing and Assurance Standards Board (IAASB) based on the recommendations from the working team that carried out the standard revision process.

Standards for Professional Practice of Internal Auditing have been developed to provide a benchmark for the work of internal auditors and to assist in performance of the duties of internal auditors. In view of the fact that it is rather complex to obtain the education of a professional auditor in Latvia it is important that everybody working in the area of internal audit knows and complies with these standards.

The International Standards on Auditing Board in the course of revising the Standards for Professional Practice on Internal Auditing of the Institute of Internal Auditors (IIA) has changed and supplemented them so that they would correspond to the new definition of internal auditing as well as included in the Standards the concepts of risk management, control and corporate governance from models like COSO, CoCo and the Cadbury Report in order to show that the understanding of the use of these concepts in internal auditing has improved.

1999. In June of 1999 the Board of the Institute of Internal Auditors approved by voting a new definition of internal auditing and a new framework of professional practice. Both decisions were based on proposals submitted by the working team and a special committee of the institute whose task was to examine the compliance of the existing standards and methodological guidelines to the internal audit work in practice. The working team concluded that there is a considerable inconsistency between the guidelines and the current practice and that a new framework is required for entering of the profession into the 21st century. In order to achieve this goal the Institute of Internal Auditors developed a new framework for the professional practice of internal auditing. Development of new standards is a part of the professional practice framework development process. As soon as the framework is finally established there will be a three-level methodical guidelines available for the internal audit profession:

· <u>Ethics and standards</u> This includes the Code of Ethics and the Standards for Professional Practice of Internal Auditing. All obligatory methodical guidelines will be in the process of their development passed for open discussion to all representatives of the profession and they are highly important for professional activities in the area of internal audit.

· <u>Practice guides</u> Practice guides are the optional methodical guidelines constituting the main part of the Red Book. The professional issues committee is developing these practice guides in detail and creating new guides in the areas that haven’t been covered before. Although the practice guides are optional they represent the best IIA approved practice in the implementation of the Standards. Practice guides can partially assist in interpreting the Standards or use them in specific areas of internal auditing. Although some practice guides are attributable to all auditors, others are developed for the needs of specific industries, specific audit objectives or special geographical regions.

· <u>Development and practice aids</u> Development and practice aids are the educational products, scientific research papers, workshops, conferences and other aid materials attributable to the professional activity of internal auditing. Aids for development and practice are developed and/or approved by the institute, but they do not meet the criteria for inclusion either in the Standards or practice guides. Aids for development and practice introduce the practicing internal auditors with the opinions of different experts hired on behalf of the IIA and sources of information detailing out the existing methods and processes for the development of internal audit employees as well as provides information relevant for other processes.

Within the new framework the development of three types of standards is planned:

a) attribute standards;
b) work performance standards; and
c) implementation standards.

<u>Attribute standards</u> discuss the characteristics of those organisations and persons providing internal audit services. <u>Work performance standards</u> provide with the

description of internal audit services and also the quality criteria for assessment of the performance of these services. Attribute and work performance standards apply to all internal audit services. Implementation standards in fact are more expanded attribute and wok performance standards defining the standards for specific internal audit assignments within a very wide range of audit and consultancy services. These standards contain also the guidelines referring to a particular industry, region or type of audit services. Attribute and performance standards are completed in fact and some implementation standards for the provision of audit services are developed.

4.2. The framework and analysis of standards for the professional practice of internal auditing

4.2.1. Introduction

In the introductory part of the Standards for the Professional Practice of Internal Auditing (SPPIA) first of all the definition of IA and the description of the framework of these standards is given that the users of the standards must be aware of to facilitate their application.

Internal Auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. Internal auditing 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 audit is realised in different legal and cultural environments, in entities of different sizes and organisational structures with different objectives. Internal audit is performed by persons either working in or outside these entities. The said differences may affect the internal audit practice in every particular environment. However, compliance with the Standards for the Professional Practice of Internal Auditing is critical to ensure the performance of the obligations of internal auditors.

The objective of the Standards is as follows:

1**. *to draw the basic principles*** showing what the internal audit practice should be like; 2. ***to define the basic guidelines*** to perform a wide range of internal audit activities for adding of value as well as for the promotion of these activities;

3. ***to establish the basis*** for evaluation of internal audit;

4. ***to enable*** the improvement of the organisation processes and operations.

Standards consist of Attribute Standards (series 1000), Performance Standards (series 2000) and Implementation Standards (series nnnn.Xn). Attribute standards discuss the

organisation of internal audit and the characteristics of internal auditors. Performance standards describe the substance of internal audit and include the quality criteria according to which the quality of the said services can be assessed. Attribute and performance standards are applicable to the internal audit services as a whole. Implementation standards determine the application of attribute and performance standards to specific types of work objectives (for example, the compliance audit, cases of fraud investigation or control self-assessment projects).
There is only one set of attribute and performance standards, but several sets of implementation standards; there is an individual implementation standard established for each internal audit core area of activity. Originally the implementation standards were developed for audit (designated 'A' after the number of the Standard, e.g., 1130.A1) and for consultancy services (designated 'C' after the number of the Standard, e.g., C1).

4.2.2. Attribute Standards

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.

> **1000.A1 –** The nature of assurance services provided to the organization must be defined in the internal audit charter. If assurances are to be provided to parties outside the organization, the nature of these assurances must also be defined in the internal audit charter.
>
> **1000.C1 –** The nature of consulting services must be defined in the internal audit charter.

1010 – Recognition of the Definition of Internal Auditing, the Code of Ethics, and the *Standards* in the Internal Audit Charter

The mandatory nature of the Definition of Internal Auditing, the Code of Ethics, and the *Standards* must be recognized in the internal audit charter. The chief audit executive should discuss the Definition of Internal Auditing, the Code of Ethics, and the *Standards* with senior management and the board.

1100 – Independence and Objectivity

The internal audit activity must be independent, and internal auditors must be objective in performing their work.

1110 – Organizational Independence

The chief audit executive must report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. The chief audit executive must confirm to the board, at least annually, the organizational independence of the internal audit activity.

> **1110.A1 –** The internal audit activity must be free from interference in determining the scope of internal auditing, performing work, and communicating results.

1111 – Direct Interaction with the Board
The chief audit executive must communicate and interact directly with the board.

1120 – Individual Objectivity
Internal auditors must have an impartial, unbiased attitude and avoid any conflict of interest.

1130 – Impairment to Independence or Objectivity
If independence or objectivity is impaired in fact or appearance, the details of the impairment must be disclosed to appropriate parties. The nature of the disclosure will depend upon the impairment.

> **1130.A1 –** Internal auditors must refrain from assessing specific operations for which they were previously responsible. Objectivity is presumed to be impaired if an internal auditor provides assurance services for an activity for which the internal auditor had responsibility within the previous year.

> **1130.A2 –** Assurance engagements for functions over which the chief audit executive has responsibility must be overseen by a party outside the internal audit activity.

> **1130.C1 –** Internal auditors may provide consulting services relating to operations for which they had previous responsibilities.

> **1130.C2 –** If internal auditors have potential impairments to independence or objectivity relating to proposed consulting services, disclosure must be made to the engagement client prior to accepting the engagement.

1200 – Proficiency and Due Professional Care
Engagements must be performed with proficiency and due professional care.

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

> **1210.A1 –** The chief audit executive must obtain competent advice and assistance if the internal auditors lack the knowledge, skills, or other competencies needed to perform all or part of the engagement.

1210.A2 – Internal auditors must have sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organization, but are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud.

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

1210.C1 – The chief audit executive must decline the consulting engagement or obtain competent advice and assistance if the internal auditors lack the knowledge, skills, or other competencies needed to perform all or part of the engagement.

1220 – Due Professional Care
Internal auditors must apply the care and skill expected of a reasonably prudent and competent internal auditor. Due professional care does not imply infallibility.

1220.A1 – Internal auditors must exercise due professional care by considering the:

- Extent of work needed to achieve the engagement's objectives;
- Relative complexity, materiality, or significance of matters to which assurance procedures are applied;
- Adequacy and effectiveness of governance, risk management, and control processes;
- Probability of significant errors, fraud, or noncompliance; and
- Cost of assurance in relation to potential benefits.

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

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

1220.C1 – Internal auditors must exercise due professional care during a consulting engagement by considering the:

- Needs and expectations of clients, including the nature, timing, and communication of engagement results;
- Relative complexity and extent of work needed to achieve the engagement's objectives; and
- Cost of the consulting engagement in relation to potential benefits.

1230 – Continuing Professional Development
Internal auditors must enhance their knowledge, skills, and other competencies through continuing professional development.

1300 – Quality Assurance and Improvement Program
The chief audit executive must develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity.

1310 – Requirements of the Quality Assurance and Improvement Program
The quality assurance and improvement program must include both internal and external assessments.

1311 – Internal Assessments
Internal assessments must include:

- Ongoing monitoring of the performance of the internal audit activity; and
- Periodic reviews performed through self-assessment or by other persons within the organization with sufficient knowledge of internal audit practices.

1312 – External Assessments
External assessments must be conducted at least once every five years by a qualified, independent reviewer or review team from outside the organization. The chief audit executive must discuss with the board:

- The need for more frequent external assessments; and
- The qualifications and independence of the external reviewer or review team, including any potential conflict of interest.

1320 – Reporting on the Quality Assurance and Improvement Program
The chief audit executive must communicate the results of the quality assurance and improvement program to senior management and the board.

1321 – Use of "Conforms with the *International Standards for the Professional Practice of Internal Auditing*"
The chief audit executive may state that the internal audit activity conforms with the *International Standards for the Professional Practice of Internal Auditing* only if the results of the quality assurance and improvement program support this statement.

1322 – Disclosure of Nonconformance
When nonconformance with the Definition of Internal Auditing, the Code of Ethics, or the *Standards* impacts the overall scope or operation of the internal audit activity, the chief audit executive must disclose the nonconformance and the impact to senior management and the board.

4.2.3. Performance Standards

2000 – Managing the Internal Audit Activity
The chief audit executive must effectively manage the internal audit activity to ensure it adds value to the organization.

2010 – Planning
The chief audit executive must establish risk-based plans to determine the priorities of the internal audit activity, consistent with the organization's goals.

2010.A1 – The internal audit activity's plan of engagements must be based on a documented risk assessment, undertaken at least annually. The input of senior management and the board must be considered in this process.

2010.C1 – The chief audit executive should consider accepting proposed consulting engagements based on the engagement's potential to improve management of risks, add value, and improve the organization's operations. Accepted engagements must be included in the plan.

2020 – Communication and Approval
The chief audit executive must communicate the internal audit activity's plans and resource requirements, including significant interim changes, to senior management and the board for review and approval. The chief audit executive must also communicate the impact of resource limitations.

2030 – Resource Management
The chief audit executive must ensure that internal audit resources are appropriate, sufficient, and effectively deployed to achieve the approved plan.

2040 – Policies and Procedures
The chief audit executive must establish policies and procedures to guide the internal audit activity.

2050 – Coordination
The chief audit executive should share information and coordinate activities with other internal and external providers of assurance and consulting services to ensure proper coverage and minimize duplication of efforts.

2060 – Reporting to Senior Management and the Board
The chief audit executive must report periodically to senior management and the board on the internal audit activity's purpose, authority, responsibility, and performance relative to its plan. Reporting must also include significant risk exposures and control issues, including fraud risks, governance issues, and other matters needed or requested by senior management and the board.

2100 – Nature of Work
The internal audit activity must evaluate and contribute to the improvement of governance, risk management, and control processes using a systematic and disciplined approach.

2110 – Governance
The internal audit activity must assess and make appropriate recommendations for improving the governance process in its accomplishment of the following objectives:

- Promoting appropriate ethics and values within the organization;
- Ensuring effective organizational performance management and accountability;
- Communicating risk and control information to appropriate areas of the organization; and

- Coordinating the activities of and communicating information among the board, external and internal auditors, and management.

2110.A1 – The internal audit activity must evaluate the design, implementation, and effectiveness of the organization's ethics-related objectives, programs, and activities.

2110.A2 – The internal audit activity must assess whether the information technology governance of the organization sustains and supports the organization's strategies and objectives.

2110.C1 – Consulting engagement objectives must be consistent with the overall values and goals of the organization.

2120 – Risk Management
The internal audit activity must evaluate the effectiveness and contribute to the improvement of risk management processes.

2120.A1 – The internal audit activity must evaluate risk exposures relating to the organization's governance, operations, and information systems regarding the:

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

2120.A2 – The internal audit activity must evaluate the potential for the occurrence of fraud and how the organization manages fraud risk.

2120.C1 – During consulting engagements, internal auditors must address risk consistent with the engagement's objectives and be alert to the existence of other significant risks.

2120.C2 – Internal auditors must incorporate knowledge of risks gained from consulting engagements into their evaluation of the organization's risk management processes.

2120.C3 – When assisting management in establishing or improving risk management processes, internal auditors must refrain from assuming any management responsibility by actually managing risks.

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

2130.A1 – he internal audit activity must evaluate the adequacy and effectiveness of controls in responding to risks within the organization's governance, operations, and information systems regarding the:

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

2130.A2 – Internal auditors should ascertain the extent to which operating and program goals and objectives have been established and conform to those of the organization.

2130.A3 – Internal auditors should review operations and programs to ascertain the extent to which results are consistent with established goals and objectives to determine whether operations and programs are being implemented or performed as intended.

2130.C1 – During consulting engagements, internal auditors must address controls consistent with the engagement's objectives and be alert to significant control issues.

2130.C2 – Internal auditors must incorporate knowledge of controls gained from consulting engagements into evaluation of the organization's control processes.

2200 – Engagement Planning
Internal auditors must develop and document a plan for each engagement, including the engagement's objectives, scope, timing, and resource allocations.

2201 – Planning Considerations
In planning the engagement, internal auditors must consider:

- The objectives of the activity being reviewed and the means by which the activity controls its performance;
- The significant risks to the activity, its objectives, resources, and operations and the means by which the potential impact of risk is kept to an acceptable level;
- The adequacy and effectiveness of the activity's risk management and control processes compared to a relevant control framework or model; and
- The opportunities for making significant improvements to the activity's risk management and control processes.

2201.A1 – When planning an engagement for parties outside the organization, internal auditors must establish a written understanding with them about objectives, scope, respective responsibilities, and other expectations, including restrictions on distribution of the results of the engagement and access to engagement records.

2201.C1 – Internal auditors must establish an understanding with consulting engagement clients about objectives, scope, respective responsibilities, and other client expectations. For significant engagements, this understanding must be documented.

2210 – Engagement Objectives

Objectives must be established for each engagement.

> **2210.A1 –** Internal auditors must conduct a preliminary assessment of the risks relevant to the activity under review. Engagement objectives must reflect the results of this assessment.
>
> **2210.A2 –** Internal auditors must consider the probability of significant errors, fraud, noncompliance, and other exposures when developing the engagement objectives.
>
> **2210.A3 –** Adequate criteria are needed to evaluate controls. Internal auditors must ascertain the extent to which management has established adequate criteria to determine whether objectives and goals have been accomplished. If adequate, internal auditors must use such criteria in their evaluation. If inadequate, internal auditors must work with management to develop appropriate evaluation criteria.
>
> **2210.C1 –** Consulting engagement objectives must address governance, risk management, and control processes to the extent agreed upon with the client.

2220 – Engagement Scope
The established scope must be sufficient to satisfy the objectives of the engagement.

> **2220.A1 –** The scope of the engagement must include consideration of relevant systems, records, personnel, and physical properties, including those under the control of third parties.
>
> **2220.A2 –** If significant consulting opportunities arise during an assurance engagement, a specific written understanding as to the objectives, scope, respective responsibilities, and other expectations should be reached and the results of the consulting engagement communicated in accordance with consulting standards.
>
> **2220.C1 –** In performing consulting engagements, internal auditors must ensure that the scope of the engagement is sufficient to address the agreed-upon objectives. If internal auditors develop reservations about the scope during the engagement, these reservations must be discussed with the client to determine whether to continue with 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.

2240 – Engagement Work Program
Internal auditors must develop and document work programs that achieve the engagement objectives.

> **2240.A1 –** Work programs must include the procedures for identifying, analyzing, evaluating, and documenting information during the engagement. The work program must be approved prior to its implementation, and any adjustments approved promptly.

2240.C1 – Work programs for consulting engagements may vary in form and content depending upon the nature of the engagement.

2300 – Performing the Engagement
Internal auditors must identify, analyze, evaluate, and document sufficient information to achieve the engagement's objectives.

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

2320 – Analysis and Evaluation
Internal auditors must base conclusions and engagement results on appropriate analyses and evaluations.

2330 – Documenting Information
Internal auditors must document relevant information to support the conclusions and engagement results.

2330.A1 – The chief audit executive must control access to engagement records. The chief audit executive must obtain the approval of senior management and/or legal counsel prior to releasing such records to external parties, as appropriate.

2330.A2 – The chief audit executive must develop retention requirements for engagement records, regardless of the medium in which each record is stored. These retention requirements must be consistent with the organization's guidelines and any pertinent regulatory or other requirements.

2330.C1 – The chief audit executive must develop policies governing the custody and retention of consulting engagement records, as well as their release to internal and external parties. These policies must be consistent with the organization's guidelines and any pertinent regulatory or other requirements.

2340 – Engagement Supervision
Engagements must be properly supervised to ensure objectives are achieved, quality is assured, and staff is developed.

2400 – Communicating Results
Internal auditors must communicate the engagement results.

2410 – Criteria for Communicating
Communications must include the engagement's objectives and scope as well as applicable conclusions, recommendations, and action plans.

2410.A1 – Final communication of engagement results must, where appropriate, contain internal auditors' overall opinion and/or conclusions.

2410.A2 – Internal auditors are encouraged to acknowledge satisfactory performance in engagement communications.

2410.A3 – When releasing engagement results to parties outside the organization, the communication must include limitations on distribution and use of the results.

2410.C1 – Communication of the progress and results of consulting engagements will vary in form and content depending upon the nature of the engagement and the needs of the client.

2420 – Quality of Communications
Communications must be accurate, objective, clear, concise, constructive, complete, and timely.

2421 – Errors and Omissions
If a final communication contains a significant error or omission, the chief audit executive must communicate corrected information to all parties who received the original communication.

2430 – Use of "Conducted in Conformance with the *International Standards for the Professional Practice of Internal Auditing*"
Internal auditors may report that their engagements are "conducted in conformance with the *International Standards for the Professional Practice of Internal Auditing*", only if the results of the quality assurance and improvement program support the statement.

2431 – Engagement Disclosure of Nonconformance
When nonconformance with the Definition of Internal Auditing, the Code of Ethics or the *Standards* impacts a specific engagement, communication of the results must disclose the:

- Principle or rule of conduct of the Code of Ethics or *Standard(s)* with which full conformance was not achieved;
- Reason(s) for nonconformance; and
- Impact of nonconformance on the engagement and the communicated engagement results.

2440 – Disseminating Results
The chief audit executive must communicate results to the appropriate parties.

2440.A1 – The chief audit executive is responsible for communicating the final results to parties who can ensure that the results are given due consideration.

2440.A2 – If not otherwise mandated by legal, statutory, or regulatory requirements, prior to releasing results to parties outside the organization the chief audit executive must:

- Assess the potential risk to the organization;
- Consult with senior management and/or legal counsel as appropriate; and
- Control dissemination by restricting the use of the results.

2440.C1 – The chief audit executive is responsible for communicating the final results of consulting engagements to clients.

2440.C2 – During consulting engagements, governance, risk management, and control issues may be identified. Whenever these issues are significant to the organization, they must be communicated to senior management and the board.

2500 – Monitoring Progress
The chief audit executive must establish and maintain a system to monitor the disposition of results communicated to management.

2500.A1 – The chief audit executive 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.

2500.C1 – The internal audit activity must monitor the disposition of results of consulting engagements to the extent agreed upon with the client.

2600 – Resolution of Senior Management's Acceptance of Risks
When the chief audit executive believes that senior management has accepted a level of residual risk that may be unacceptable to the organization, the chief audit executive must discuss the matter with senior management. If the decision regarding residual risk is not resolved, the chief audit executive must report the matter to the board for resolution

4.2.4. Code of ethics

The purpose of the Code of Ethics designed by the Institute of Internal auditors is to promote the ethical culture of the internal auditor's profession.
The Code of Ethics is necessary and is appropriate to the profession of internal auditors as it is based on the trust in an objective assurance of risk management, control and enterprise management. The Code of Ethics of the Institute of Internal Auditors extends far beyond the internal audit definition by including two critical components:
1. <u>Principles</u> referring to the profession and practice of internal auditors;
2. <u>Provisions of professional ethics</u> describing the standards of behaviour that internal auditors are required to comply with. They help to convert the principles into a practical conduct and their purpose is to guide the ethical conduct of internal auditors.
The Code of Ethics along with the Professional Practices Framework and other relevant official documents of the Institute provides assistance to internal auditors in their work.
The term 'internal auditors' **applies to the members of the institute, recipients of the IIA professional certificates or candidates as well as to those providing internal audit services within the framework defined by the internal audit definition**.

This Code of Ethics applies to both physical and legal entities providing the internal assurance services.

Any breaches of the Code of Ethics by the Institute members and recipients of the IIA professional certificates will be assessed and administrated in compliance with the Institute decisions and administrative directives. The fact that a specific aspect of conduct is not mentioned in the provisions of ethics does not mean that they wouldn't be unacceptable or discrediting, and therefore, any Institute Member, certificate holder or candidate may be held responsible by a disciplinary action.

Principles

The principles to be complied by the internal auditors are listed below.

Integrity

Integrity of internal auditors gives confidence, and therefore, provides the grounds for reliability to their judgement.

Objectivity

By collecting, evaluating and providing the information related to a specific operation or audited process internal auditors are acting at the highest level of professional objectivity. Internal auditors should balance out all respective conditions and should not in any way get influenced when preparing their judgement by either own or the interests of others.

Confidentiality

Internal auditors respect the value of and title to the information received and do not disclose this information without appropriate authorisation if not required to do so by their legal and professional obligations.

Competence

Internal auditors use their knowledge, skills and experience necessary for the provision of internal audit services.

Provisions of professional ethics

1. Integrity

Internal auditors must:

1.1. perform their work with integrity, care and responsibility;

1.2. comply with the laws and disclose to the public what is required by the law and their profession;

1.3. do not intentionally get involved in unlawful activities and events discrediting the profession or organisation of internal auditors;

1.4. respect the legal and ethical goals of the enterprise and contribute to their achievement.

2. Objectivity

Internal auditors must:

2.1. not participate in any activities or establish relationships that may interfere or that may be considered as interfering with the provision of an objective assessment. Such participation includes such actions or relationships that may be contradictory to the interests of the organisation;

2.2. does not accept anything that may interfere with or that may be considered as interfering the formation of a professional judgement;

2.3. discloses all significant facts that have been made known to them and that if not disclosed can distort the report on operations audited.

3. Confidentiality

Internal auditors must:

3.1. exercise caution in the use and protection of the information that has been made available to them during the performance of their obligations;

3.2. do not use the information in order to receive personal benefits or in any other way that would be contradictory to the law or could harm the lawful and ethical goals of the enterprise.

4. Competence

Internal auditors must:

4.1. provide only those services for the performance of which they have the necessary expertise, skills and experience;

4.2. provide only internal audit services in conformity with the Standards for the Professional Practice of Internal Auditing;

4.3. continuously raise professional qualification and improve quality of the services.

Checklist for Subject 4:

1. ***What is the role of the International Standards for the Professional Practice of Internal Auditing in the execution of the internal auditing function? Who designed these standards?***
2. ***What does the term 'professional practice of internal auditing' mean? What is its framework like?***
3. ***Describe the framework of the International Standards for the Professional Practice of Internal Auditing and the code designation of the individual standards.***

4. ***What is the role and application of the attribute standards in the provision of internal auditing services?***
5. ***How does the internal audit unit manager establish and realise the quality assurance and improvement programme? How often does the reporting take place and how is the quality reflected in the internal audit working papers?***
6. ***Interpret the most important requirements for the management of internal audit units contained in the Performance Standards?***
7. ***Which aspects of the standards are related to the risk management issues? Which areas in the aspect of risk assessment are particularly underlined in the text of the standards?***
8. ***Mention the different requirements formulated in the standards for the provision of assurance and consultancy services.***
9. ***How to interpret the principles and provisions of ethics included in the Code of Ethics of internal audit?***

Practical assignment – compare the requirements of the regulatory acts governing internal audit to the rules of the International Standards for the Professional Practice of Internal Auditing.

Subject 5
Description of specialised internal audit types

5.1. Scope and concept of risk-based internal audit
5.1.1. Enterprise risk management

Risk management in enterprises can be broken down into 4 levels:

1) general control environment in an enterprise; associated with the attitude from management, significance of values, several procedures already in place and the initiative at a strategic level;
2) systematic risk management process; regarding the identification and elimination of risks;
3) specific risk management programmes – for example, in respect of safety, health, environment, insurance, cash assets, reputation or similar issues; some programmes can affect certain aspects of the general risk management process while not being integrated with this process;
4) individual risk-based measures, decisions or decision making mechanisms – either within or outside the scope of the previously mentioned processes or programmes, in respect of normal or extraordinary circumstances;

(1) – general control environment in the enterprise One of the responsibilities of internal audit is to create an environment that would ensure risk management and control, fit into the overall enterprise structure and would be suitable for all enterprise structural levels. The control environment must include the following:

- a clearly formulated, coordinated enterprise risk policies and standards (that would also include a clear definition of those types and levels of risk that are unacceptable);
- respective measures, for example, audit committees, management meetings, project planning exercises, workshops for the purposes of discussing the risks and information exchange;

- clearly defined and distributed responsibilities providing for authorisations to accept and control the risk, including delegation, and providing for the assumption of liability for the risks;
- appropriate enterprise risk programmes and procedures taking account of the enterprise culture, management style and experience in risk management;
- respective measures and procedures ensuring the risk management revision process including continuous learning from experience and the storage of records.

(2.,3.,4.) – risk management and control process

Two main elements can be distinguished in this process:

- Risk assessment – consideration of consequences and probabilities;
- Risk management / control – including any safeguards against risks, use of opportunities, risk elimination, providing the necessary control.

A full risk management and control process includes 16 phases. It is the task of the internal audit unit to define its role in the process as a whole and in each of the phases separately by coordinating its activities with the persons in charge of risk management and control as well as to work together with the managers and other specialists in order to help create a control environment, structure and processes in the enterprise conforming to the business supervision requirements and business needs in the future.

<u>Stages of risk management and control:</u>

1. Gain an understanding of the main risks and agree on the necessity of the control process (including the distribution of responsibilities).
2. Perform project planning and develop the initial guidelines (definition of the main terms - what is 'risk').
3. Identify the risks and their causes (at various levels and after the process objectives have been identified and considered).
4. Analyse the risks (sort them by type).
5. Estimate the probability (by distinguishing between the inherent and residual risk).
6. Assess the possible consequences.
7. Group the risks according to significance (classification, for example, significant, insignificant, priority).
8. Define the general risk strategy (by considering the options and taking into account the enterprise attitude towards risk in general).

9. Evaluate the efficiency and adequacy of the existing risk and defence procedures (if not already done before).
10. Prepare specific action plans (based on the strategy/methods and taking into account the available resources).
11. Implement the plans.
12. Introduce risk management processes in day-to-day activities (giving a signal about potential risks resulting from certain circumstances).
13. Follow the progress and the results (measures for risk elimination).
14. Review (evaluate the efficiency of the procedures, status of the risks, changes in the environment on a regular basis).
15. Review the existing control procedures, activities and information, if necessary.
16. Report (within and, if necessary, also outside the enterprise about its process, measures, results).

Numerous well known methods exist that can be used in each of the stages. An auditor – idealist will execute the control procedure over the analysis of risk management process in each of the above mentioned stages. A practically oriented auditor could wish or he could be asked to assume the responsibility for the process or for certain tasks. However, an auditor should not assume the responsibility for the risk management process as a whole. This is and remains the duty of the management. The Turnbull Report is therefore imperfect when defining risk supervision as the requirement for the auditors. Auditors have the option to decline risk management procedures by transferring them to the managers and other employees in charge - to those, in fact, who have these responsibilities included in their job descriptions. This is one of the work objectives of the internal audit unit.

<u>Internal audit process</u> The audit of risk management and control process, and specific programmes can be performed in two levels, by using the traditional systems approach to audit in both cases:

- review of process as a control system by evaluating the structure of the risk management system, comparing it to the reality and the requirements of the environment, and by assessing, how efficiently and properly it operates;
- analysis of the risk management process, systems and project control procedures, ensuring that the system operates appropriately and efficiently, and is properly used. This is an idealistic view assuming that

the auditor is not a risk management expert. This approach includes a lot of correct aspects, however, using a purely idealistic approach is not the best thing to do. Both approaches described should be used in combination.

Regardless of the limited knowledge, experience and authorisations, auditor may apply standard methods in order to assess the general control system and operation in each of the levels.

Risk management process

Risk management process is an inseparable component of good corporate governance. It is an interactive process enabling to improve the decision making process.

The term of risk management usually means a systematic and logical approach ensuring the identification, analysis, assessment, monitoring and supervision of risk and the necessary information at any operational, enterprise or process level by thus reducing the possible losses and promoting opportunities. Risk management equally refers to both the identification of opportunities and the prevention of losses.

The principal components of the risk management process are as follows (see Figure 5.1).

a) environment creation – establishment of the strategic, organisational and risk management environment that would serve as the basis for the management process and procedures; Criteria must be defined that would be used for risk assessment and the structure for analysis;
b) identification of risks – the underlying risks, the identification of 'what', 'why' and 'how' for further analysis;
c) risk analysis – identification of the existing control environment. Risk analysis in view of the probability of risk and the existing control environment. In the process of analysis the potential consequences and their probability/possibility should be taken into account. Probability and consequences can be used in the appraisal of the risk level.
d) Risk assessment – comparison of the anticipated level of risk with the criteria put forward. Therefore, the possible risks can be listed pursuant to the management priorities. If some individual risk factors are estimated as 'low' this risk may be classified as an acceptable risk and further measures may not be required;

e) Measures applicable to existing risks – accept and ensure supervision of low priority risks. Develop and implement a specific management plan in respect of other risks by providing the necessary financing;
f) Risk supervision and review – supervision and review of the risk management system and its operation taking into account any changes in the environment and the affecting factors;
g) Internal communication process and consultations – continuously communicate with the parties involved (both internal and external) in every stage of the risk management process.

The risk management process is applicable in a whole spectrum of enterprise structural levels. It can be used both at the strategic level and at the operational level. It can be applied to specific projects by assisting in the adoption of certain decisions or providing control in certain risk areas.

In every stage of risk management the documentation and storage of information necessary must be ensured which enables independent audit performance.

5.1.2. The concept of risk-based internal auditing

Internal audit takes account of the interrelation between the objectives, risks, factors of the environment and the control procedures in enterprises, their operations and relationships with other parties. A good auditor tries not only to identify and assess the risks present in the business process, but also to evaluate and perform the analysis of activities undertaken by the management and risk assessment procedures. The significance of risks has increased in recent years. Possibly the risks themselves have increased which is due to the changes in environment, the existing uncertainty, indefinite conditions and the wide possibilities of choice. Money is lost, reputation damaged and people hurt. This is the reality and it should be noted that there will be always mistakes. However, there are unavoidable risks, while other risks are acceptable. There is always a possibility to perform certain activities – choose between several options. Many people and enterprises use it and their profit and financial position depends on it. Others try to avoid risk.

Risk control and management is possible only and solely by understanding the concept of risk, but different people understand it differently. Internal auditors have the possibility to explain their views about risk to others, provide advice how to assess the risks by using the systems-based approach and succeed in business. Within the scope of their activities auditors have the possibility to discuss the three primary causes of risk with the management:

- the probability of different options;
- incomplete information;
- lack of control.

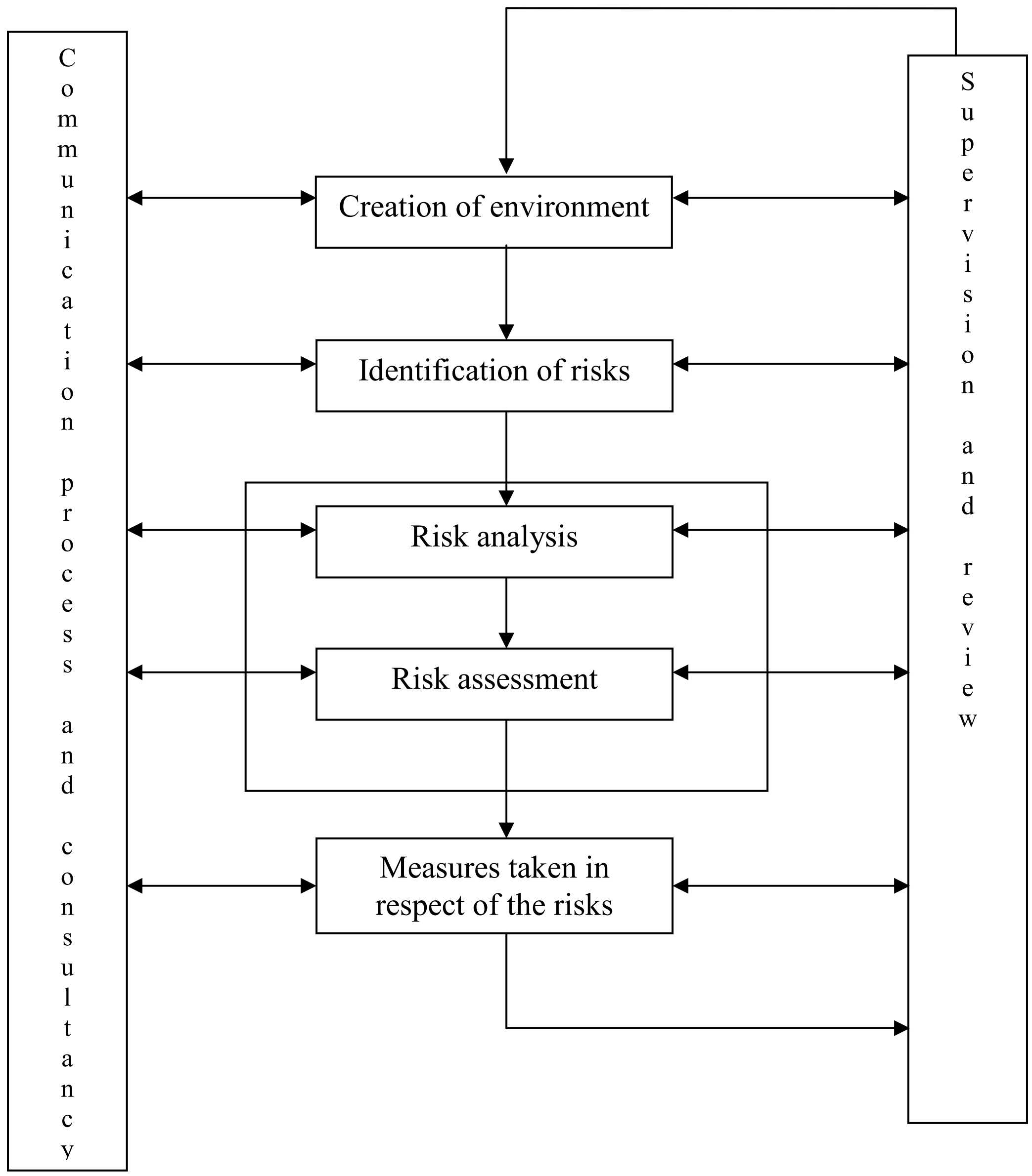

Figure 5.1. **Risk management process**

It is important for the management to understand the distinction between the inherent and the residual risk and that the auditor could discuss the possibilities of preventing or eliminating of the existing risk.

The management techniques for <u>the existing risks</u> are as follows:

a) to accept – means to take for granted an aspect of operations (for example, in a situation of a large car park choose civil insurance only instead of the KASKO policy);
b) transfer – to allow somebody else to assume the risk (by insurance of property through execution of contracts with insurance companies);
c) eliminate – to prevent risk (for example, discontinue the production of a problematic product);
d) act – carry out efficient measures to reduce the risk (for example, to store goods with a long delivery period in several warehouses).

Residual risk is that which after considering all conditions and measures is still current for the operations of an enterprise. There are mainly 3 causes of this residual risk:

1) ***informed decisions*** taken based on the selected risk strategy or a judgement which is based on the consideration that:
   - it is not cost-efficient to carry out additional measures in order to reduce or prevent the risk;
   - another strategy is more appropriate;
   - it is beneficial to take the risk;
   - other factors have a much greater significance;
   - the situation will most certainly change;
   - other control procedures exist that compensate for the residual risk in the respective area.
2) ***obstacles*** preventing from the performance of further activities for risk elimination or prevention, for example, shortage of time, shortage of resources, practical impediments, no technical possibilities etc.
3) ***sufficient attention not paid*** as there are other priorities, also due to negligence, ignoring of risk, indifference etc.

<u>The main duties and responsibilities of internal auditor when performing a risk-based audit</u> are ***to assess the justification or adequacy of measures or passivity in certain cases, to analyse and discuss the alternatives and opportunities existing under certain circumstances and to persuade the management about making the changes required***.

The main goal of the discussion is to agree on an **acceptable** risk level. It is not included under the responsibilities of the auditor to define **the standards** or **the acceptable levels** for risks, control procedures and operations. This is the responsibility of the management. Managers of all levels must adopt this difficult decision about the extent to which an enterprise is willing to accept or reconcile with a certain risk by considering its effects and consequences on the operations of the enterprise. To completely avoid the risk could be the ultimate goal under certain circumstances, but it should be always considered what it would cost.

It is the task of internal auditor to identify whether certain standards and measures exist, to discuss their appropriateness and adequacy to the environment and to provide information on their potential or current consequences and effect on the enterprise operations.

In respect of the control environment the term 'reasonable assurance' cannot be used. Managers must define the following:

- the level of assurance that would need to be achieved within the control framework;
- how much would it be worth 'to pay for' (using factors like time, effort, money);
- how would it be possible to achieve it;
- what to do with the imperfections and residual risks, their effects.

It should be taken into account that risk is a relative term and risks are interrelated. The significance of risks largely depends on the circumstances and the attitude of the parties involved. Their differences over time can create unnecessary confusion. By channelling more resources for the elimination or prevention of a single risk usually another risk increases by thus causing a conflict. For example, by installing cameras for monitoring of employee recreation rooms in order to improve the productivity of the employees the risk that the relationships between the management and the rest of the personnel will deteriorate. The term 'risk' can be applied to any problem or issue. Risk management and control procedures must cover all areas of activity. Similarly the work of internal audit should be also planned.

There are three main areas that apply to the management, department managers, specialists, third parties and internal auditors:

1. Risk identification, prevention and management control – ***as part of the management process and management responsibilities***.
2. Independent risk identification and assessment – ***as part of the internal audit process and responsibilities of auditors***.

3. Use of risk analysis in audit planning – ***by carrying out the strategic and operational planning, based on the risk assessment and other criteria***.

Internal audit by performing independent risk identification and assessment process (2) can express itself in several ways:

a) as part of a classical (operational level) systems-based audit the purpose of which is to obtain the assurance that the control procedures are being correctly and effectively applied;
b) as part of a higher level systems-based audit by providing assurance about the overall business supervision process, fraud, financial control, issues of environment etc.;
c) as part of the management report on the provision of an adequate internal control system (where such reports are required to be submitted);
d) as part of the management procedures in order to estimate the risks;
e) as an independent assessment of inherent and residual risks (it must be made sure though that the auditors have the expertise sufficient to perform the assessment).

More and more internal auditors in the whole world are capable of helping enterprises and their managements in the establishment of efficient risk management structures and systems. The risk management process is a part of the control system described in the COSCO model and the Turnbull Report. The process of identification of goals is one of the component parts of this model. Risks represent the obstacles preventing from the successful achievement of goals. The risk identification process, based on the COSCO model, includes the following:

- The timely identification of business, operational, financial and compliance risks. These risks refer to issues of the market situation, technology, reputation, integrity;
- Assessment of the probability of risks and the resulting effects in the enterprise context;
- Definition of priorities for the distribution of the existing resources, setting of specific goals.

<u>Several strategies exist for the actions of internal auditors:</u>

1. recommend the designing of a formal risk assessment and management system that would constitute a part of the control system and standard management procedures;

2. stimulate the risk management process; a typical example would be a project at the department level in the result of which information would be acquired on the risks, their effects, the necessary control procedures, system, processes would be established;
3. take an active part in similar projects without the necessity to assume their leadership;
4. share the experience and knowledge of the levels of risk and the types of risk control;
5. carry out a new risk management system and project audit: a) by evaluating the operational control process; b) by evaluating the overall enterprise control environment;
6. rely on the work of other specialists;
7. savienojot risku novērtējuma rezultātus ar vadības apliecinājumu, ka tiek nodrošināta atbilstoša iekšējā kontrole; tas varētu nozīmēt dažādu pūļu un projektu koordinēšanu;
8. introduce risk-based methods (for example, self-assessment of control procedures in the audit process already at the planning level;
9. share the competencies with others;
10. perform an independent analysis/assessment of inherent and residual risks;
11. delegate these responsibilities to the consultants.

Many approaches in designing of control systems do not include an important factor like the introduction of a risk-based performance culture in the enterprise. A large majority of auditors can confirm that this is not an easy work. Patience and time is needed when working with the managers, the audit committee, the personnel in order to introduce and explain the concept as such as well as to test its compliance. Workshops, discussions and other activities must be organised that can help to achieve the desired results. Management has the final say in any case. It should be able to cope any possible consequences and effects of the risks in cases when full control is not ensured or no appropriate measures are taken for the prevention or elimination of the risk. It is the duty of the auditors to agree on an acceptable resulting or residual risk level.

5.2. Operational or performance audit

Performance audit is one more type of audit that focuses mainly on the final results of the operations, i.e., helps to determine the best operational performance that would enable to achieve the enterprise goals. Sometimes auditors treat risks identified in the annual planning process in a manner that is too subjective. When the plan is developed and approved, individual areas audited are selected according to the principle of rotation (auditing at least once in every 3 years). Based on this information a report is prepared on the adequacy of the control mechanisms in the audited area in the achievement of the system or process goals. A drawback of this system is that the attention is not focused on the overall goals of the enterprise. For example, in auditing the payroll the audit devotes much attention to the issues or personnel recruitment and dismissal, the accuracy of salary payments and accounting estimates, but it is often forgotten that generally this is only the financial side of the issue of human resource planning and management. Therefore, regardless of the fact that the enterprise budget indicates the necessity for auditing of personnel costs, the most important issues are as follows:

- How are the work plans and goals reduced to the necessary amount of workforce;
- The quality and competence of the enterprise personnel with the help of which it tries to achieve a competitive edge;
- How are the issues of shortage and redundancy of personnel addressed;
- How does the human resources department and the unit managers cooperate in order to coordinate business planning and personnel requirements;
- Are there any human resource plans developed and are they analysed and controlled on a regular basis;
- What measures are used in the regulation of the level of personnel (by adapting to a changing amount of work), measurement of output and comparison to the industry 'standards'.

The scope of audit that needs to be carried out to provide answers to all these questions may seem completely unrelated to payroll audit. But in fact, it is not so. It is possible that the reason for the performance of payroll audit or any other activity based on figures is to a certain extent related to our traditional view on finances and accounting. Such audits are performed according to the following criteria:

- Goal: provide an opinion on financial control;
- Area: auditing of financial and justifying documents;
- Competencies: accounting and audit;
- Focussing on: previous results;
- Accuracy: absolute;

- Standards: articles of association/accounts and/or contracts;
- Reporting: facts based on which an opinion is formed.

The main problem is in planning. If the budget is used as the basis for risk assessment, finances will be the audit driving force. While if the risk assessment is based on a comprehensive performance analysis a different set of criteria is defined:

- Goal: analysis and improvement of performance methods;
- Area: operational processes;
- Competencies: wide scope;
- Focussing on: the existing and future performance;
- Accuracy: relative;
- Standards: best experience and practice;
- Reporting: recommendations for the improvement of operation.

By using this approach in human resources planning the auditor is still invited to consider the issues of payroll, but from a very different perspective, however. Focus may be on the amount of overtime, unjustified absence and sickness leave, efficiency of the payroll system and its integration with other systems or any other data enabling an efficient realisation of human resources planning.

Assessment of risks

All enterprises have business plans where they define what and when they wish to achieve as well as the means for achieving these goals. These business plans are usually supplemented with short-term goals and objectives. These plans are channelled down to every structural unit of the enterprise by establishing financial or other goals for each of them. If every structural unit fulfils its objectives at the desirable level the overall goals of the enterprise are also achieved. Structural units usually have business plans of their own and the enterprise lays down certain restrictions (authorisations, principles for delegation of authority, procedures and the techniques for work) within the framework of which such structural units can operate. In order to ensure that every structural unit fulfils its plan and achieves its goals, there is an organisational structure developed in an enterprise.

Performance is measured by preparing the monthly sales reports and enclosing different supporting documents - production statistics, sales information, data on the performance of the workforce, procurement, project progress reports, market information and other data becoming the basis for adoption of decisions in the future.

Audit goals must be directly related to the enterprise goals. Therefore, if the main goal is to reduce overheads, then this objective should be included among the goals of every structural unit. This becomes a risk that internal auditors must include in their plans. The majority of performance audits has a certain resemblance to the risk-based model. Its purpose is to identify a complex of performance risks, estimate the relative importance of these risks and arrange them by priority so that they would be all included in the planning cycle. Analysis of all structural units and departments, interpretation of strategic goals and policies must be carried out in the context of their operational goals, as well as the understanding of each structural unit goals and the related risks must be achieved. Such risks can be expressed by simply using references to the area of activity of the respective structural unit - production, marketing, transport, finances, procurement, research, personnel etc. The importance of each risk area must be assessed according certain criteria. Some auditors perform this importance analysis simply by discussing the business risks with the management. Others possibly support the view of the management with more complex research by assessing each risk according to specific criteria:

- Materiality (total value of revenue or expense);
- Level of systems or performance control;
- Amount of transactions;
- Legislative threat;
- Consequences of incorrect management;
- Complexity;
- Potentially lost opportunities;
- Relative internal control standard (compared to other activities);
- Tendencies of fraud;
- Existence of a clear procedural management;
- Level of interest shared by the management.

The use of an evaluation system facilitates the identification of relative risks. It helps auditors in the appraisal of high, medium and low risks. After the audited activities have been identified, appropriate methodology must be developed.

The primary issue in methodology is the audit goal:

a) to identify all operational goals of a structural unit and ensure their compliance with the overall enterprise business strategy;

b) ensure that the management is oriented on an efficient and economical performance by establishing plans; defining goals, managing processes, evaluating performance according to its criteria;

c) to evaluate the control mechanisms in order to ensure that systems and processes correspond to the desirable level of performance while ensuring that fixed assets and business interests are protected from the losses or other threats;

d) to review information flows to ensure completeness, accuracy, credibility and timeliness of decision making;

e) to evaluate efficiency and effectiveness by comparing with the respective benchmarks and best experiences of other enterprises;

f) to ensure the fulfilment of social responsibility through enterprise performance and transaction integrity and compliance.

These criteria are derived from the traditional systems approach by identifying those measures that would help to improve the performance.

A risk-based plan identifies those structural units and their operations that constitute the largest obstacles in making the success. In order to gain a greater understanding on such operations the preliminary survey or ***primary audit*** must be conducted.

<u>Primary audit</u>

Primary audit consists of:

- Review of the data contained in the audit file, previous audit reports and documents of the structural unit;
- Initial discussions with the unit manager;
- Review of the business plan;
- Analysis of existing budget data;
- Analysis of current sales reports;
- Summary and analysis of current data;
- Identification of current development plans or business initiatives;
- Review of the minutes of executive meetings;
- Review of guidelines issued by the structural unit managers (procedures and operating techniques applied);
- Review of the organisational structure;
- Analysis of personnel information;
- Identification of goals, objectives and control systems for all unit managers;

- Identification of local and networking IT installations serving the structural unit.

It is best to write down the information on standard forms to ensure the constancy of approach and reduce the risk that highly significant information can be omitted. Each of the above sources of information will provide expertise and information on the environment of operation. It is unlikely that the documents alone will be capable of providing all necessary information, and therefore, the auditor most probably will need special questionnaires for each department or division of the structural unit. So, for example, the following questions should be applied to the planning and budgeting function:

a) How is planning done in the enterprise?
b) Are there any long-term and short-term plans developed (auditors must receive their copies)?
c) What are the market research techniques used?
d) What is the enterprise strategy for ensuring the competitiveness of the enterprise?
e) Do any plans for the current investments exist?
f) What is the financial pressure on the enterprise?
g) How are the budgets prepared? What is the system and how it is controlled?
h) Is the workforce planning coordinated with the budget?
i) What statistical data are used in budget preparation?
j) How are the budgets controlled?
k) Are any variations/replacements allowed and in what circumstances?
l) Who receives the monthly sales reports? What measures are taken based on this information?

These questions should cover a whole spectrum of business operations and point out at the basic threats and opportunities from the management perspective. Discussions and exchange of opinion at the department level will assist in identifying the central audit issues.

When all the data are collected the assessment of information should be performed. Special attention needs to be paid to the problem areas that should be revealed after the analysis of comments on the sales reports is made and the control reports on the management goals and objectives are examined.

<u>Primary audit scheme</u>

Understanding of business

Goals/objectives, business plan, market conditions, personnel plans, production plans, sales/revenue, investment

Identification of business problems

Excessive costs, uncompetitive production, low-quality service, low productivity

Data collection

Structural, sales reports, operating performance, control reports, strategy and procedures, achievement of goals

Primary assessment

During the stage of the primary audit at least a general assessment of the systems in place for the achievement of goals is done. Thus the auditor would have seen if, for example, the standards or goals are not set, budget establishment guidelines not developed, the procedures either do not exist or they are not complete etc.

In order to assist the auditor in performing the assessment of the operations audited the assessment model should be used. The model identifies the top level goals of each operation within every structural unit. Auditor must define whether every goal has a certain measurable objective against which the performance can be evaluated. All measurements are based on the terms, costs or quality or the combination of all three factors. Auditor must identify what is the information that the manager is going to receive, how and when it is received in order to control the performance and compare it with individual goals and objectives.

Any draft plans auditors should discuss with the unit managers by thus communicating the following to him:

- any facts disclosed in the primary assessment;
- any obvious drawbacks in the control mechanisms;
- the list of potential topics selected in the primary assessment and their selection criteria;
- the input of the manager himself in the process, i.e., support to audit.

Therefore, during this stage 1) the primary assessment has been made in the following aspects:

a) identification of top level goals;
b) evaluation of objectives;
c) evaluation of information systems integrity.

2) the audit plan is developed with the following structure:

a) preparing a list of potential risk areas;

b) alignment to the risk model;

c) agreeing the audit plan with the unit manager.

Audit programme

The audit programme consists of there parts: *systems audit, efficiency and effectiveness analysis, performance evaluation.*

The programme is a transfer from the planning stage to the preparatory works and should be considered a finalised action plan. This would ensure:

- a systematic approach to auditing;
- the grounds on which each auditor is given his assignment;
- the means for controlling the quality of auditing;
- a possibility to perform the training of less experienced auditors;
- a basis for summary of the facts identified during the audit;
- the assistance to next audit groups in preparing their future plans.

Stage 1 of the audit programme – Systems audit

System is a complex of interrelated operations or processes which take place in a certain order with the purpose of achieving specific goals.

First step is the system identification, segregation and placement within a certain context. Then it must be clarified who owns the system and who uses it, the goals set forth by the management must be understood and then the system must be documented through a combination of questions and flowcharts. Notes should be tested by going through the documented system step by step in order to make sure whether the auditor has understood correctly how the system works and who is involved in it. The purpose of the system can be very different – payroll, purchase of goods and services, documenting the amount of output produced etc.

Next step – direct assessment for the performance of which Form B should be used (in Appendix). This process includes:

- identification of the goals of control;
- risk assessment;
- identification of the main control mechanisms;
- evaluation of their appropriateness;
- compliance testing (application of the control mechanisms);
- wording of opinion (for this purpose a further and more detailed testing may be required in order to evaluate, how efficient is the control mechanism in practice).

Stage 2 of the audit programme - Economy, efficiency and effectiveness

Stage two of the audit programme focuses on the assessment of economy, efficiency and effectiveness. In order to achieve it, proper principles for resource planning, approval, control and evaluation should be in place in an enterprise. The programme is based on the resources input to the system, its processes and the final output, i.e., a series of interrelated operations. 'Input resources' comprise the level of expenditure, use of the services, costs per unit, labour and performance indicators. The issue here is whether the resources of sufficient amount and quality are used at the lowest possible cost. The 'process' element focuses on the manner or operation and comprises the corporate, procedural, activity, responsibility, scope of work and operation levels. 'Final output' is the assessment of the final result by taking into consideration the degree of achieving the desired results. This is an issue about the goals, measurement of final results and preparation of the report. In practice all three components overlap to some extent and it is both easier and faster to develop methodology taking account of the whole three elements in the whole. A standard form can be applied here as well.

Thus the systems audit identifies the way the system operates, its borders, goals set forth by the management, the input system resources, processes and the final output, the principal control objectives for the input resources, processes and final output, evaluation of the control mechanisms, appraisal of compliance, effects of inappropriate or non-existent control mechanisms and recommendations for improvement. Therefore, due to a common approach used in the performance of the primary audit and primary assessment, auditors now have the necessary information at their disposal to carry out the assessment of efficiency, economy and effectiveness.

The auditor puts down the title of the system and each of its component in the form. So, for example, the main components of procurement are the identification of requirements, purchase, receipt and approval of payments. Each of these operations has its input resources, processes and final outputs, and the output of the requirement should constitute the input resources of purchasing, while the output of purchasing should be the input of the receipt etc.

Auditors are recommended to test five interrelated aspects or each system component:

- goals;
- organisation;
- budget and planning;
- management information;

- performance control.

A range of questions can be listed for each of the aspects. The answers obtained must be evaluated and verified in order to assess whether it is possible to offer valuable recommendations that would improve the economy, efficiency and effectiveness.

Table 5.1

Testing of system components

Objectives	• Are they defined? • Can they be measured? • Are any individual responsibilities found in the job descriptions? • Are the performance criteria defined along with the annual measurable objectives based on time, cost and quality indicators? • Is there any feedback available from the client regarding the level of service, quality of performance and the final results? • Are there any methods of reporting identified and approved?
Organisation	• Is the enterprise organisational structure suitable for the achievement of goals? • How is the operating strategy defined and implemented? • Are the directives, procedures, operating techniques and delegation of authorisation complete, appropriate and clear to those working with it? • Are the strategies and operating methods regularly reviewed and alternatives examined (several options considered and studied)? • Are the resources used in full: what is the action in situations of rapid growth and fall? • Is it possible to achieve the goals by using alternative means (implementation of new technologies, implementation of the highest level of automation, use of sub-contractors, leasing etc.)?
Budgets	• Is the budget designing process properly managed? • Are the revenues/costs properly controlled? • Are the financial data controlled, how and how often? • Is there any short-term, medium and long-term plans introduced? • Does the plan correspond to the corporate goals and legislation/regulatory acts? • Does the plan provide for alternative scenarios for operating in changeable economic circumstances?
Management information	• What information is prepared, how often and for whom? • Is the information complete, accurate, credible and timely? • Is there any other information available/necessary? • At what moment/stage the reports are prepared? • What is the purpose of their preparation? • Is the strategy being reviewed by taking into account the information contained in the progress report?
Performance control	• Are the performance control assessment mechanisms efficient? • Are the criteria realistic and represent best business practice? • Is the performance permanently linked to the objectives, especially in situations when any changes are made?

	• Who and how does the performance assessment, and how this person reports for his work?

Auditor will have to adjust the questions to the needs of system testing. Data collected for the system testing can be also used in the analysis of economy, efficiency and effectiveness of the system, although this should be done very carefully. For example, the worksheet of a sub-contractor is viewed by the systems audit from the cost perspective (do they fit?), but in efficiency assessment this same element is assessed from other aspects – alternatives for execution of contracts, whether the work was at all necessary, has it been performed efficiently (sufficient quality, minimum consumption of resources, the lowest possible costs, achievement of the desired results etc.). One needs to take a creative approach here.

Stage 3 of the audit programme – Performance evaluation

This is the final stage of the audit programme. The results of the first two stages should be evaluated by taking into account the following considerations:

- Appropriateness of the goals for assessment of management standards or achievements. For example, whether net profit is an acceptable evaluation criterion or are there any other controllable results.
- Are the instructions misunderstood, irregularly applied or are there any deviations permitted.
- Is the personnel capable of performing its duties?
- Does the personnel assume any responsibility?
- Are the activities appropriately controlled?
- Are there any overlapping responsibilities or are there any areas that where the employee time is wasted?
- Aren't the resources wasted or improperly used?
- Are the communication signals clear or is the organisational structure too complicated?
- Is the personnel distributed regularly, purposefully?
- Are all of the processes required and give a positive contribution to the entire system?
- How appropriate are the criteria applied by the management for the assessment of efficiency?

Development of recommendations based on the audit conclusions requires a lot of expertise and competencies. They should be realistic, carefully examined, analysed and evaluated before proposing them as potential alternatives to the existing solutions. Very often radical alternatives provide with the best solutions, but it should be always tested how such solutions have proven themselves in practice in other enterprises by using properly established performance criteria. This audit component requires a lot of time and work. Very often the employees themselves come forward with the best ideas and they are willing to devote a lot of time to achieve an efficient implementation of their proposals into reality.

The principle of cooperation in performance audit is very critical – before the preparation of the final version of the suggested improvements all proposals should be discussed and agreed upon by the unit managers. As the recommendations could reflect the imperfections of the current management operation they should be presented in a tactical, constructive, confident and simple manner. Most importantly, the recommendations must receive support, they must be effective, relevant and timely.

5.3. Quality assurance of audit performance

An important issue in the work of auditors is to ensure the quality of auditing for the work to be efficient and to provide an increase in the value of the organisation. Internal auditors must perform their work responsibilities in accordance with the regulatory requirements and in compliance with the guidelines provided in the standards. Therefore, in order to ensure quality auditors must know the regulatory framework and standards and follow the changes in the documents binding for their work.

Along with the development of IA in public administration auditors have the possibility to obtain certificates of different levels providing the environment for acquisition of further expertise on internal auditing, including the knowledge of standards for the professional practice of internal auditing, the knowledge regarding the regulatory documents and the various aspects of internal audit areas which guarantees the quality of auditing by facilitating their growth and also an increasing prestige in public administration.

Currently in Latvia internal auditors can obtain new knowledge and to enhance the existing by attending the different level training courses organised by the Ministry of Finance at the School of Public Administration. Subject to the CM Regulations No 307 'Certification of Internal Auditors' auditors can write the respective qualification papers specifically defined for each level, defend them and receive a certificate of either the first or the second level. The next step is to acquire an international internal audit certificate.

In accordance with the Standard for the Professional Practices No 1300 entities must introduce the quality assurance system for the IA structural unit. The unit manager is in charge for a proper functioning of this system and this system includes all aspects of IA activities and ensures continuous supervision of the auditor work efficiency.

The quality of IA work is ensured through the following activities:

- *Recording of auditors' work-time*

Auditors perform the recording of their work-time by entering the time used each day on the performance of a certain audit assignment by segregating the individual stages of each audit assignment and recording separately their auditing activities. Upon completion of the audit the course of the assignment is analysed and an evaluation is carried out of the audit assignment documented in the Audit Action Plan.

- *Ensuring supervision of auditor activities*

The supervision of auditor activities is ensured with the help of another auditor who is appointed as the auditor in charge for the specific assignment. The responsibilities of the auditor in charge include the supervision of activities by other auditors and the review of working papers for a specific audit by using the 'four eye principle'. The initials of the auditor in charge on the working papers and the date of verification serve as the designation of the supervisory review performed. Review of the working papers is performed with the purpose of ensuring that the audit has been performed in line with the procedures provided in the structural unit and the Standards for the Professional Practices of IA, and as working documentation presents sufficient evidence for the preparation of the audit report.

- *Performance of the IA unit self-assessment*

Within the framework of quality assurance it is recommended to perform the assessment of compliance of the auditor activities with the Standards for the Professional Practices. At least once in every 5 years external auditors perform the audit of the activities of the IA structural unit. The IA unit manager must report on the results of the external audit to the manager of the entity.

- *Performance of self-assessment of the IA unit auditors*

Pursuant to the CM Regulations 'Procedure for Evaluation of Activities and Performance Results of Public Servants' the self-assessment and evaluation of auditors is carried out once a year. This is conducted by a senior degree audit official within the structural unit. The IA unit manager is evaluated by the manager of the entity.

- *Raising of auditor qualifications*

Auditors must improve their knowledge, skills and competencies every year by attending courses and workshops. Each auditor is provided with the possibility of annual training for raising of qualification in accordance with the auditor training plan approved within the unit. This is prepared based on the level of knowledge of the auditors and the knowledge requirements specific for the operations.

- *Quality review of audit files*

Prior to the closure of an audit file the auditor in charge – the team manager performs the quality review of the audit file. The audit file is reviewed and assurance gained that there are all the necessary documents and audit evidence included in the audit file and that these are processed in the required procedure. A checklist is completed for the review carried out – Audit file compliance review.

It is recommended that the quality review of audit files is performed not less than once a year by using the random selection technique. This is carried out by the IA unit manager or his deputy. In these reviews focus is given to the document presentation, numbering, references, audit evidence, conclusions made etc.

Checklist for Subject 5:

1. ***Describe the most important components of the risk management process.***
2. ***What are the main tasks of internal auditors when performing risk-based audits?***
3. ***Explain the specifics of the performance audit compared to the systems audit.***
4. ***On what audit objectives the performance audit methodology is based?***
5. ***What are the activities performed by an auditor during the preliminary survey or the primary audit?***
6. ***What is the difference between the performance audit programme and the audit programme designed within the systems audit?***
7. ***Explain what are the techniques used for ensuring an adequate internal auditor performance quality?***

Subject 6

Concept of internal control system

6.1. Concept of internal control
6.2. Components and structure of internal control system
6.3. Objectives and tasks of internal control system
6.4. Principles of internal control system development

6.1. Concept of internal control

If controlling from the functional point of view is the coordination of management, planning and control as well as of the information provision sub-system development and interrelation, and the overall adaptation of the system, then this makes us think that in the process for designing of each above mentioned sub-system certain rules and principles must be complied with, that would ensure its efficient use in the achievement of the enterprise strategic and operational goals. This fully applies also to a control system where one of the types critical to the enterprise operations is the ***internal control***. The need for internal control is due to both objective and subjective aspects, and therefore, the necessity for creation of an internal control system is secured in the LR CM Regulations No 585 'On the Conduct and Organisation of Accounting' (21.10.2003). Regulations provide that the management of an entity is responsible for the establishment of an accounting control system which is a part of the overall ICS. Thus it is worthwhile clarifying the concept, objectives, functions, structure and other ICS issues in each entity.

Already at the end of the 19th century an analysis of the Accounting and Auditing Office goals of the Krupps Company shows that the various reviews performed are aimed at the establishment of an enterprise internal order system or organisational form. It must be designed so that any event or business transaction at any enterprise operational level would not be left unnoticed, i.e., its 'transparency' is ensured. The bigger the enterprise, the more difficult it is to meet this requirement. A particularly defining moment is, when – as the size of the enterprise grows, the necessity arises to introduce additional mechanisms providing for sufficiently safe supervision of the business transactions.

The management of a business enterprise in general must develop and implement measures in two most significant levels: a) ensuring of efficient enterprise performance – profit-making; b) development and adaptation to changing environment of the enterprise development and organisational schemes presented in detailed guidelines and instructions. These detailed guidelines and instructions in their entirety are called the enterprise internal control system (see Figure 6.1).

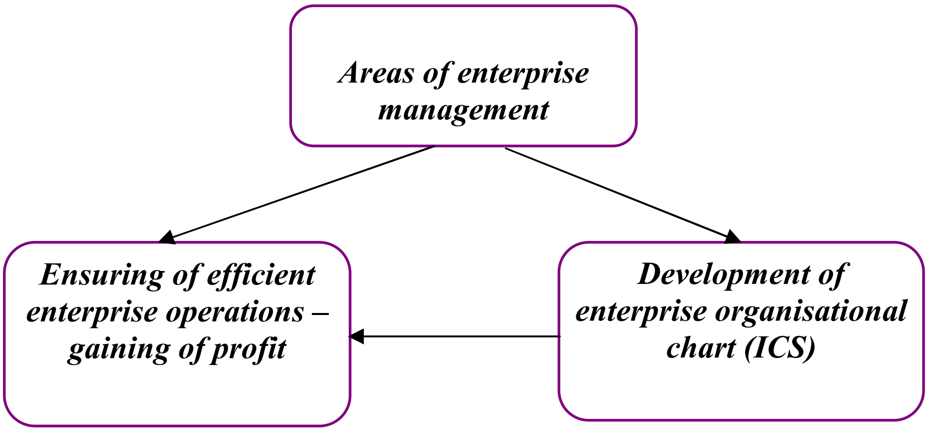

Figure 6.1. Role of internal control systems in the enterprise management process

The fact whether an enterprise will make or will not make any profit fully depends on the type and industry of the business – the peculiarities of production, agriculture, commerce, services, brokerage industries, as well as on the skills of the enterprise management to plan and realise their business by adjusting to the specific economic circumstances. Therefore it can be said about this area of management that its results *depend on the substance of business processes*, while the mechanism for making every business transaction overseeable or 'transparent' is basically unrelated to a certain industry or type of transactions, i.e., the general principles for development and realisation of ICS are common for all enterprises and *do not depend on the substance of business processes*. Such ICS rules as the segregation of duties, preparation of documentation in a language that is understandable to third parties, signatory rights and mandatory documentation of all transaction are binding for all industries and all business types. The fulfilment of these ICS standards and instructions enable the achievement of the desired business results.

The word 'control' has originated from the French word 'contre – rôle' meaning a countercheck or additional checking. In substance, this is the comparison of the existing types of object or transaction execution with a certain desirable state of affairs (the comparison of 'Is' – 'Should be'). The desirable status ('Should be') is fixed in the standards and instructions of ICS. Therefore, there should be a comparable link between the actual and the desired condition. This task is performed by the enterprise internal audit. In opposition to controlling which depends on the business processes in substance and performs the current assessment of the actual information from the point of view of efficiency, internal audit evaluates against the ICS criteria and standards the individual stages of the process of enterprise activities, the overall results, methods and decision making. The central objective of ICS and internal audit is to protect the enterprise from any losses of property and information and to ensure the achievement of its goals. However, this objective should not be treated statically and unilaterally, because very often the application of the ICS instructions and standards should be interpreted in dynamics by taking the realistic changes in the future into consideration. In this respect, it is quite possible that an item of fixed assets which is not acquired does not mean that the enterprise would not have followed an originally developed strategy, but that the area of activity of the enterprise has been flexibly changed. This means that the ICS requirements should be regularly changed in accordance with the changing external conditions.

6.2. Components and structure of internal control system

The definition of ICS is provided in the International Standards on Auditing:

'*ICS means the organisational plan adopted by the management as well as all the methods and procedures necessary in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records and the timely preparation of reliable financial information*.'

It shows in detail that the ICS of an entity is a set of measures ensuring a successful operation (in accordance with the management's objective) by further detailing what are the exact techniques to be used in the achievement of positive operating results and prevention of different undesirable activities. It is important to find out what the components of ICS are, and how they are interrelated:

In accordance with the International Standards on Auditing ICS consist of the **control environment** and **control procedures**.

Control environment means the internal conditions for realisation of control defined by the overall awareness, attitude and actions regarding control and its importance in the entity, as well as those external conditions directly affecting the course of business and therefore also the execution of internal control. Control environment depends on different factors that either facilitate or prevent the execution of internal control procedures:

- the entity's management objectives;
- the instruments and operating style of the management;
- the entity's organisational structure;
- the methods of defining the rights, duties and responsibilities;
- management control system, including internal audit;
- the functions of the board of directors;

- the personnel policies;
- the impact of external circumstances.

Control procedures: means the entity's operating policies, personnel responsibilities and activities that have been introduced and are being realised in addition to the control environment which management has established for the operations associated with a higher level of risk. The specific ICS procedures include:

- reconciliations;
- checking the arithmetical accuracy of the records;
- controlling applications and the environment of computer information systems;
- maintaining control accounts and trial balances;
- approving and controlling of documents;
- comparing internal data with external sources of information;
- comparing the results of cash, security and inventory counts with accounting records;
- limiting direct physical access to assets and records;

comparing the financial results with budgeted amounts etc.

The initial view may be that control procedures are primarily related to information processing and correct preparation of accounting data. However, after the concept and objectives of ICS are examined in more detail it becomes clear that ICS are far beyond issues directly attributable to accounting system functions. The following types of activities can be distinguished in accounting systems:

- recognition of transactions;
- calculation of indicators;
- classification of transactions;
- entering into the records;
- totalling and summarising the results;
- submitting the output data to the respective authorities.

If the accounting system is supplemented with the internal control procedures this may provide a certain assertion to the enterprise management that the assets are protected from unauthorised use or placement, and that the accounting entries made in the preparation of financial information can be relied upon.

However, it follows from the list that by incorporating the control procedures only in the above mentioned activities 'transparency' would only be achieved for the processing and summarising of the information related to completed business transactions; but in such a situation the signing of contracts, the execution of the transactions themselves and other processes would not be ensured by control procedures and the enterprise management would not have no assurance regarding the quality of their execution. In order to ensure the supervision of all areas of activity of the entity and the assurance to management on the compliance of the internal processes to the objectives of the entity, internal control procedures should be provided for and implemented in every area of activity of the entity.

The structure of ICS is made of certain interrelations between its components, which is illustrated graphically in Figure 6.2. The enterprise operational control can be sub-divided into two levels:

Level 1 – independent external audit that in accordance with the LR law 'On Annual Reports' performs the review of information included in the annual report by evaluating whether this information gives a true and fair view of the position of enterprise assets and liabilities. The performance of external auditing is indirectly related to the ICS of an entity. During the preliminary stage of an assessment of the ICS is made and the auditor gains assurance on the efficiency of ICS, and therefore, also on the probability with which the accuracy of the information processed by ICS can be relied on. The more complete the internal control is, the smaller the scope of work to be performed during the audit. Therefore it is possible for the external auditor to express his opinion to the management of the entity regarding the drawbacks and inefficiencies of ICS. External auditors also collaborate with the internal audit service and upon the permission from the entity are in the position to use the internal audit working papers in the process of testing.

Level 2 – notionally highlights those control activities undertaken within the entity by individually distinguishing the ICS as a set of measures and control procedures which are incorporated in different stages of business, and *the internal audit service* performing the internal supervision over the execution of these ICS, their evaluation and proposal development for the implementation of new control procedures. This in particular is the principal difference between 'ICS' and 'Internal auditing' that does not allow to consider these concepts identical as their substance, types of performance and objectives are different. Thus ICS consists of the control environment and control procedures of the most varied nature. In the chart below control procedures are divided in four categories:

- ✓ control by using the resources of the entity;
- ✓ special control principles;
- ✓ process integrated control;
- ✓ standards for controlling the results.

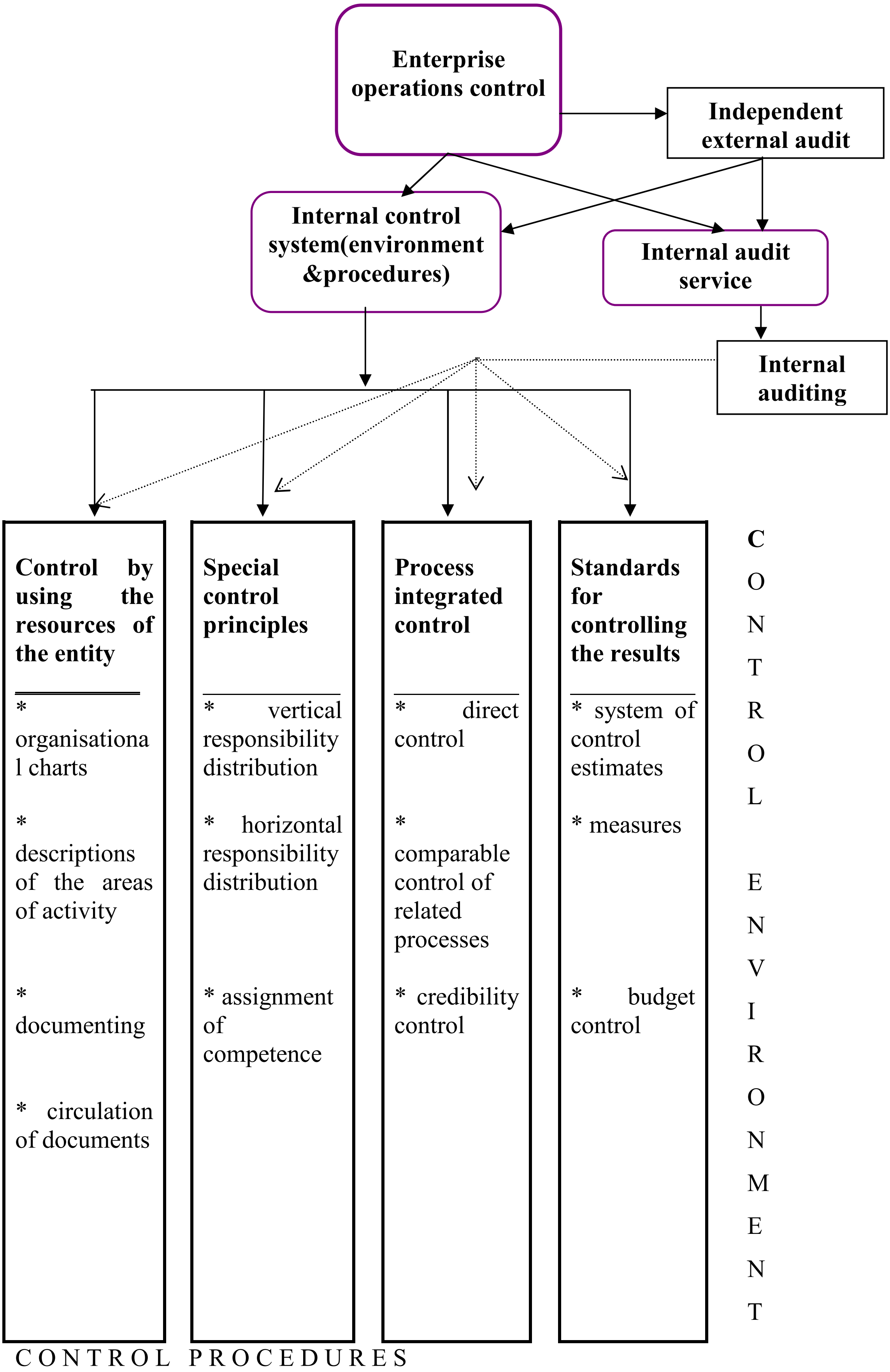

Figure 6.2. Types of entity operational controls and the ICS structure

Organisational resources as control procedures are expressed not only by structuring the entity as an economical unit, but mainly by its informative role. This means that the employees of an entity that have been introduced with its strategy, organisational structure, the plan for circulation of documents and other most important documents of the entity would be capable of performing their work responsibilities in a much shorter time and in a better quality.

Special control principles are related to the distribution of responsibilities both at the horizontal level - between the structural units of the same level, or between the employees within a single structural unit, and at the vertical level – by establishing subordination among the structural units of several levels and employees. The assignment of competence of the structural units at any level or of individual employees is highly significant. The borders of competence are established by the overlap between the horizontal and vertical distribution of responsibilities, but it should be recorded in the job description.

Process integrated control is a manual or automated, i.e., computerised control activity, performed additionally at some stage of information processing, which helps to assure the accuracy or credibility of the information obtained from the database or as a result of calculations. Also in this situation several control techniques can be applied (direct control, comparable control of related processes, software executed control etc.).

Standards for controlling the results mean such control procedures assisting, in accordance with the strategy of the entity, to set definite achievable results in certain areas of activity. These may be expressed both as the measures of time and financial resources budgets as well as the values defined by the measures used in financial performance analysis enabling the control of the extent to which the entity has achieved the set targets.

It should be understood therefore, that the variety of control procedures covers an extremely wide range of activities, from setting of global goals to arithmetical testing of the requisite information or data of particular documents. This allows the entity, when developing its ICS, to choose the most appropriate control procedures for the areas with the highest exposure to risk. Furthermore, the control environment is merely a background that may either positively or negatively affect the process and efficiency of these selected procedures.

6.3. Objectives and tasks of internal control system

ICS is necessary to achieve the following general goals:

1. Safeguarding of assets;
2. Ensuring of accuracy and reliability of financial accounts;
3. Compliance of the business of an entity to the statutory provisions;
4. Following the operating strategy of the entity;

The first two goals constitute **accounting control**.

The last two constitute **administrative control**.

The objectives of accounting control are to ensure the following:

- Transactions are executed in accordance with management's authorisation.
- All transactions are treated and recorded in accordance with a proper accounting system.
- Access to assets (tangible items) of the entity would only be possible in accordance with management's authorisation.
- The existing assets and liabilities correspond to the information recognised and presented in the accounting records.

External auditor during the review of annual accounts is interested in the fulfilment of the objectives of accounting control as well as confirms the legality of the transactions performed, but the question on how is the operating strategy developed by the entity complied with remains in the competence of the entity.

In order to realise the general goals of ICS in practice they are identified in the form of sub-goals that would also perform the function of ICS assessment criteria that could be used by external auditors in their work. Five sub-goals or objectives are distinguished:

- completeness;
- accuracy;
- existence;
- authorisation;
- safeguarding of assets.

Completeness is a critical condition by itself, because it is fixed in the legislation. This means that the entity must take care about the timely and complete recognition of each transaction in the accounts. For example, for each sales transaction the turnover, accounts receivable and the tax amounts must be recognised in full. This obligation of recording is achieved particularly with the help of the ICS. The sub-goal or objective of completeness is highly important also in the work of external auditors. If full information of the state of affairs is not available to the auditor, he cannot provide with a reasonable assessment of the annual report. If completeness is not ensured, such an entity cannot be audited or it is necessary to make a qualified report. Therefore, it is important for the entity itself that this completeness is ensured and that all documental evidence available is presented.

<u>Accuracy</u> The necessity for an accurate recording of all business transactions seems to be a trivial objective of the ICS, otherwise accounting loses its purpose. This sub-goal, however, has a great role in the assessment of control efficiency. The accuracy of preparing the accounting and annual reports is a constant principle and the failure to comply with this principle may lead to a distorted – untrue financial information.

<u>Existence</u> One of the ICS requirements is to record only past transactions, by therefore excluding the possibility of accounting records disclosing some entries of fictitious transactions. The criterion of existence for the balance sheet item 'Accounts receivable', for example, can be checked by reconciling the amount of debt recognised in the accounting records with the respective customer – debtor. Upon the receipt of a written statement expressing consent to the amount of debt assurance is obtained on the real existence of the transaction executed.

Authorisation or empowering means that ICS must provide assurance that any transaction for which there are accounting entries made in the records has taken place with the respective authorisation of the entity's management. In the light of the large amount of business transactions that each entity makes with the surrounding environment it is unrealistic to receive such an authorisation in each particular case. Therefore, authorisation is defined as a general permission to execute constantly recurring business transactions. Often these general authorisations are received at the moment of signing the employment contract. General authorisation is also, for example, a directory of standard prices showing at what prices the goods should be sold, the credit limits issued to the customers or an authorisation to a particular sales agent for an independent execution of sales in the amount of a certain turnover limit. A whole range of authorisations work this way in each process of sales, and the management of the entity does not have to issue orders or instructions on each business transaction. Special authorisation applies to transactions outside the scope of the general authorisation. In this situation the management of the entity does not allow the execution of the transaction without a special authorisation. Fore example, a used company car must be sold which is under the responsibility of the manager of the car park as stated in the technical inventory list. This means that no sale can take place without notice to this employee.

Safeguarding of assets is associated with certain methods reducing the probability of situations when the entity has to suffer various kinds of property and information losses and damage. These are mainly the physical safety measures for locking safely the goods warehouses, for example, or to implement the fire-safety measures in cash safe deposits, design the password system for software etc. Such safety measures are very important in respect of accounting transactions. Safeguarding of accounting transactions as well as the documents in their physical format is one of the most important conditions for provision of accounting completeness. Unauthorised or secret destruction of documents may incur unimaginable losses. Safeguarding of assets also includes those measures ensuring a limited access of each employee to material values and documents.
This sub-goal is in fact achieved almost completely also when all four above mentioned objectives are fulfilled as well as if the principle for the distribution of duties is realised.

The ICS goals correspond to the objectives of the external auditor in the review of annual accounts. A pre-condition to that is the fact that none of the ICS general or operational objectives does not prevent or does not contradict the activities of the external auditor. Pursuant to the LR laws 'On Accounting' and 'On Annual Reports' management of the entity has the obligation to perform accounting in such a way as to be able to create a true and fair view on the position of the entity's assets and liabilities, as well as to prepare the annual accounts. These statutory obligations for which the management of the entity is in charge are 'put on the shoulders' of the accounts department. In order to gain assurance that these obligations are duly being realised the management of the entity must design an supervision system or an ICS.
On the other hand, the review of annual accounts has been introduced to prevent or at least to detect any potential misstatements and falsifications of the balance sheet data as well as any fraud by the management of the entity in general resulting in deviations from the system of accounting and balance sheet preparation as provided by the law and as recorded in the articles of association. External auditors as experts must show within the

scope of their assignments that a no such deviations are found in the annual report of functioning entity. In his opinion the auditor must indicate if the accounts and the annual report comply to the provisions of the law and the company articles of association, as well as if the data presented in the annual report on the asset and financial position correspond to the actual situation. Therefore, the goal of the auditor is to assess the compliance of accounts to the laws and the articles of association, and is likewise the goal of the ICS.

6.4. Principles of internal control system development

6.4.1. Internal control system functions and underlying principle

In order to understand and analyse the ICS its functions should be described, i.e., the activities on which the operation of ICS is focused, as well as the underlying principle indicating the necessary pre-condition for the functioning of this system. In any economic conditions these functions may obtain a meaning differing to a certain extent and their means of expression can be different.

The above named general objectives of ICS specify that the system should be established in such a way as to avoid and prevent from the loss of assets, accounting inaccuracies and other errors of the management process. This enables the formulation of the two basic ICS functions: **safeguarding** or preventive function and **detection** function.

The function of safeguarding or the preventive nature of the ICS is expressed in the *elimination of the potential for error*. The control procedure integrated in a certain stage of the enterprise operations simply would not allow an error to be made. This approach presupposes that the number of control procedures should be as big as to ensure safeguarding against making errors and execution of unauthorised operations in all activities of a high risk level.

Detection or deductive function is targeted on disclosing of past errors. A control system of this type identifies mistakes and cases of fraud and gives a signal to the management system to correct the error and its effects as soon as possible. The level of exposure of control detection functions depends on the period of time elapsed from the moment of detection of the error to the realisation of the measures for its correction. The later the control identifies the error, the less favourable the results.

If the ICS is designed to be more focussed on error detection, the costs of the system itself would be smaller, while the potential amount of the losses due from exposure to the error will be considerable. At the same time those ICS that are designed for safeguarding of the entity's assets and its operations from errors would be more expensive in terms of costs. The difference is that when detecting errors the ICS has to test all past business transactions, while by preventing errors the system should be designed so as the transaction execution already incorporated the necessary control procedures by thus creating a larger amount of work and increasing the costs for internal control.

Segregation of duties is adequately considered to be the underlying ICS principle. Without this principle the existence of ICS is doubtful, because this principle particularly excludes or reduces the potential for the employees upon mutual agreement perform in their interests unauthorised, loss-bearing transactions for the enterprise.

The basic rules for the segregation of duties are as follows:

- the duties must be segregated in such a manner that none of the enterprise employees could gain any personal benefits with the use of any unregulated activities;
- none of the activities to be performed should remain uncontrolled.

It is recommended to organise the segregation of duties based on the possibility that the process of any transaction can be split into four stages:

- authorise, give permission to perform a business transaction;
- process – execute the business transaction;
- know the assets, inventories, material values related to the business transaction performed;
- make the accounting entries for the completed business transaction.

These four stages should not be concentrated under the work responsibilities of a single person. The employees giving orders can also be performing the executive operations of a specific transaction or execute the control procedures that in the ideal situation covers all these four stages of transaction execution, but not for one and the same but for different business transactions. Segregation of duties includes a more detailed segregation of the execution operations of this transaction in completion with the appropriate control procedures. Therefore, if a single employee, for example, executes the registration of a document and the recording of data, then the responsibilities of another one should be included the checking of accuracy of the operations performed. This combination of transaction execution and execution of control by another employee has acquired the name of '**the four eye principle**'.

By applying the ICS underlying principle in specific circumstances certain requirements are established for distribution of the transaction execution stages among employees. This is critical in such conditions when the above segregation of duties cannot be fully applied; for example, if the number of employees is too small to involve four people in the execution of each transaction. In those situations at least the minimum requirements must be complied with ensuring the prevention of fraud, error and losses of property. These include:

1) The necessity to separate the management and the record-keeping operations for the physical property items. The importance of this requirement can be best illustrated by an example.

If the duties of a warehouse manager who is in charge of the inventories also include the keeping of accounting records he is in a position to sell certain items from the warehouse without the consent of the management and to derecognise the items sold from the accounts. Thus there would be no deviations of the actual inventory balances from the accounting balances disclosed.

2) It is necessary to segregate the authorisation to execute business transactions from the management of the physical property objects of the entity. No person in the entity should have the possibility to issue orders to execute a transaction with the part of the property of the entity that he is materially responsible for.

Accountants keeping accounts payable should not be given the authorisation to sign payment orders. The combination of these duties may give rise to the possibility to transfer cash to a fictitious supplier and mismanage the assets of the entity.

3) The necessity for segregation of accounting tasks between the employees of the accounting unit.

The worst case scenario is when the accountant is solely responsible for the representation of all business transactions in the accounting records, starting from the processing of original documents and ending with the completion of the general ledger data and preparation of annual reports. Also, if the scope of work is not unmanageable it is very likely that some errors that the accountant is unaware of may remain undisclosed. In the area of sales it is purposeful to separate such duties as keeping of accounts receivable, transactions with doubtful accounts receivable and accounting for cash received for the repayment of claims.

4) Segregation of operational responsibility and accounting.

If one and the same structural unit of an entity is in charge for accounting and documentation referring to its own operations, it is quite possible to present these operations in a manner that is very far from the real situation. For this reason the accounting work should be entrusted to a special unit – the accounting or controlling department. It must be noted here that the establishment of an accounting department does not depend solely on the necessity for segregation of duties, but also from the point of view of the control tasks.

6.4.2. Principles of internal control system development

It is useful for the entity employees, and particularly its management, to be aware of and to understand the conditions and main concerns involved in designing of ICS. These can be looked for in the regulatory enactments of the Republic of Latvia, but there is no specific guidance provided in the Republic of Latvia legislation on the requirements for designing of ICS. Therefore a lot of unclear questions arise for which it is difficult to find answers.

One of the most critical questions is: <u>if all entities need to establish this system.</u>

Remembering that one of the most important ICS objectives is to prevent any property and information losses of an entity it becomes clear that the ICS procedure must be introduced in those sectors of business which the management of an entity is no more capable of supervising and managing effectively without the help of other employees. The reasons for this could be very simple – the growth of the entity in size, diversity and complexity of the areas of activity, production and in automation of data processing. At the same time in smaller entities of a simple structure, small amount of operations and number of personnel the owners and managers are capable to keep all processes taking place within their scope of attention to a sufficiently high degree, besides, it is unlikely that the execution of own transactions would be fraudulent by nature. Therefore, it is necessary to implement only some ICS procedures there, for example, physical measures for the safeguarding of assets – safe deposits, fire-proof cabinets, security guards, administrative control for ensuring of business legality as well as other control procedures dependent on certain circumstances.

The development of ICS is largely related to the organisation of business. It is determined by the necessity to 'develop' the control procedures at certain stages of operation of the entity. Therefore, by splitting up business activities in structural units each entrusted with permanent tasks, as well as by defining the units and departments where the execution of some tasks would be either integrated or coordinated, concurrently the issues of planning and execution of control procedures would need to be solved. There are three areas of activity that are characteristic of the ICS development:

1) structural organisation;
2) establishment of the necessary pre-conditions for the personnel;
3) performance of measures for safeguarding of assets.

(1) – The first objective of structural organisation is the segregation of the business functions in homogenous cycles, for example: procurement, sales, production, logistics, finances and accounting, insurance, human resources and social area, automated data processing. Each of the cycles is specific by its material values and information flows ensured by the employees of the specific structural unit of the entity. In the area of ICS an important objective is to create structure-dependent pre-conditions for the segregation of the above given four transaction execution stages (the segregation of the issuance of orders, execution of transactions, supervision of property and accounting operations). In other words, upon defining the authorisations in an entity the principle of segregation of duties and 'the four eye principle' must be taken into consideration.

By grouping the processes taking place within a certain cycle by individual activities, the types of controls to be used should also be provided for the achievement of the basic objectives of ICS: authorisation, accuracy, completeness, existence, safeguarding of assets. If necessary, each activity or data processing is completed then with a control procedure relevant for one of the ICS sub-goals. The possible order and contents of the ICS procedures for data processing of the sales cycle is illustrated in Figure 6.3. The ICS activity must be understood here as the information processing process followed by control activities. Information processing is a range of activities resulting in new information, respectively the initial substance of information has been modified. These activities in the form of sequential steps can be an object of control but never will be the control itself. Information processing is, for example, the recording of the incoming invoices in the journal, entering of any claims and turnover in the accounts, preparation of outgoing invoices, making payments upon purchase of inventories, calculating the depreciation. Control is a range of activities comparing the current state of affairs with the required. In case of any deviations the processing activity is transferred for adjusting. Otherwise further processing takes place.

Activities of control can be distinguished not only by the sub-goal set forth, but also by the **type of activity** and the **method of technical execution**.

According to the type of activity the types of control are as follows: comparison control, information transfer control, numerical control etc.

According to the method of technical execution there is manual control and automated control.

The instruments of structural organisation are the internal manuals containing instructions for the performance of certain activities, including control procedures. Workplace descriptions also belong to this group, where the principle of segregation of duties and the four eye principle and organigrams are taken into account.

(2) – Establishment of pre-conditions for the personnel as one of the areas for designing of ICS is significant in regard of the fact that the efficiency of the ICS primarily depends on the extent of credibility and competence by which employees execute control procedures. This does not only require to recruit specialists possessing a certain level of qualification, but also to ensure that the employee will receive for his work an amount of remuneration adequate for his level of education and experience, that he will be able to use a paid annual vacation leave as well as to receive other compensations and benefits. Only this way it is possible to at least partially guarantee the credibility of the employees.

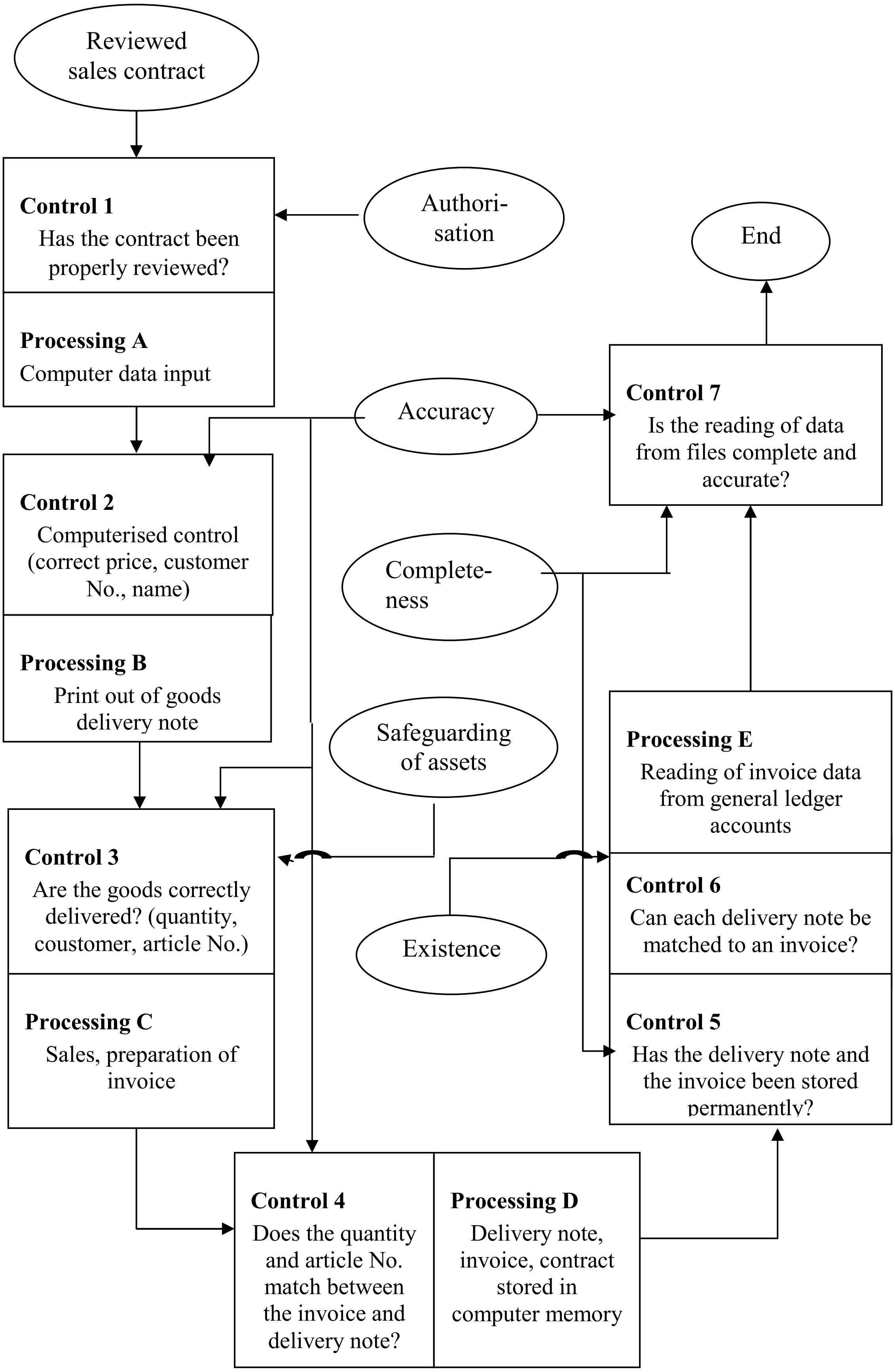

Figure 6.3. Processes of the sales cycle and the presentation of ICS

As one of the pre-conditions for personnel recruitment the possibility for the employee to take adequate decisions in certain situations in choosing an option of action and collaborating with the co-workers must be mentioned, i.e., certain borders of competence must be defined in the job description, within which an employee may realise his creative abilities and experience. Finally, the option to replace an employee if necessary should be provided for so that work performance and execution of control procedures of constant quality is ensured during the whole year including vacation leaves.

(3) – Performance of measures for the safeguarding of assets means to foresee what physical safety measures it would be useful to select and to which asset items they should be applied. First of all, it is necessary to identify the areas for safeguarding (movable and real estate property, including fixed assets, production and sales inventories, computers and massive data storages). Then the appropriate means for safeguarding must be chosen: alarm devices, fire-proof cabinets, safe deposits or restriction of access to valuable moveable items or to open a security department and carefully follow the performance of its activities. Depending on the extent to which the property items must be safeguarded and maintained, the **direct** and the **indirect** safeguarding can be distinguished.

The direct safeguarding prevents from unauthorised operations, respectively, it is restricting the access to persons other than the personnel and also eliminates the impact of environment on the respective property item.

Indirect safeguarding is the so-called 'document route', i.e., it is realised through a restriction provided for with the help of a certain document. For example, the receipt of cash in bank without a cash receipt issued to a certain, authorised person is not possible.

To safeguard replaceable and irreplaceable property units there is an entire system of organisational provisions developed in an entity which completed with the principle of segregation of duties does not allow unauthorised persons to access the business. From the point of view of an external auditor the level of asset safeguarding describes the fulfilment of an important ICS objective which, on its turn, affects the accounting accuracy measurement and compliance with the legislation. If an entity incurs, for example, losses due to burglary the auditor, first of all, is interested whether this decrease in assets is presented in the accounting balance sheet and the income statement, and how it will be achieved. It is then being checked whether there haven't been similar cases before and whether the principle of continuous operation is not compromised.

The measures designed for all areas of application of ICS pertaining to the internal control system are included in the organisational plan of the entity. This may be both in descriptive and graphical form. One of the most significant components of the entity's organisational plan is to include segregation of duties – considered as the basis of ICS.

Thus the description for the internal control system is established in the form of a set of documentation. Based on the above outlined concept for its development the ICS documentation consists of the instructions of the individual cycles of business, document flowcharts, description of the segregation of duties. The set of this documentation finalises the ideal sequence of various activity processes in each cycle, the procedure for completion and processing of documents, the control procedures to be performed and the reporting system for the controls performed, for example, organigrams, workplace descriptions, flowcharts, written instructions etc. ICS instructions must provide with a clear prescription for the action, and furthermore, they cannot be understood otherwise as intended. The ICS documentation set is also used by external auditors in their activities. He can test and assess the ICS of the entity only if the necessary internal control concept documented in a written or in a graphical form is available.

Documentation in the internal control system plays a role also in another aspect – as a certificate of a completed control procedure. Any control is effective and provides the results only if it is checked by whom and how it is performed. For this purpose each control procedure must be assigned its own specific procedure for the documentation of performance. Documentation here means that the employee or the computer performing the respective control procedure prepares a written statement that within the range of his duties he has also performed the comparison of the current state of affairs to the standard. With this document which is generally a handwritten note on the supporting document for the transaction, for example, in the form of initials, signature, a uniquely identifiable symbol or code, the controlling person takes over the responsibility for the results of this comparison. With the unambiguous transfer of the responsibility to the employee the specific activity progresses towards the achievement of the ICS objectives, because in a situation like this a person will make the effort to avoid any errors. However, it must be remembered that any written statement of a control activity still does not prove that this control has actually taken place. The fact that control is being certified in such a way enables its testing later. Unfortunately, results of the tests have demonstrated that even if there is a note of completion, it has not been always actually done, but it may be that only due to the lack of time the note on the performance of a control procedure has been made.

This poses certain problems for external auditors when choosing his position in respect of the ICS assessment. It can be assumed that the control has actually taken place, but an appraisal of reliability of the work done by the employee performing this control needs to be made. External auditors can apply other methods of testing here, for example, secret observation by establishing how reliable is the note on the document as evidence.

6.4.3. Operational limits of the internal control system

As the internal control system functions, both general goals and sub-goals should be achieved. As in every area of human activities also here a preliminary identification of all potential goals is not possible. This means that as the conditions significantly change, also the list of goals can be changed. Another obstacle could be the potential existence of several competing goals a parallel realisation of which is impossible. ICS goals do not compete with each other, but difficulties may arise in respect of other enterprise operating goals. One of these competing goals is profitability. A pre-condition to a successful business is that each business transaction is profitable. In this situation there is sense in complying with the ICS goals to an extent only. Generally, it can be said that the ICS will only be profitable if the costs of ICS are lower than the results gained in the effect of the ICS operation. This means that for the efficiency assessment of ICS the expenditure needed for designing and implementing of ICS should be set against the 'revenues'. 'Revenue' from functioning of ICS is a reduction in potential losses, but its assessment both in natural and monetary terms is quite difficult. In fact, only by summarising the experience gained one can decide which most important property units and information processing tasks should be safeguarded by introducing additional control procedures. The overall trend in the development and implementation of ICS is the applied common sense, i.e., any cash should be spent on control only if it brings any benefits to the entity: prevention of burglary, fraud, information leaks and other undesirable activities.

<u>ICS profitability requirement</u> cannot be taken as material limitation for realisation. For further analysis let us assume that ICS operates profitably. This can be assumed because the ICS in fact is always watched over and tested within the scope of activities of internal auditors. It is always an object for the review of annual reports, whether profitable or not. The external auditor performs its assessment by analysing what the contribution given by the ICS is in the achievement of the entity's operating results and control objectives. The external auditor is only interested in the profitability of the ICS when he rather acts as a consultant in the entity than an external auditor in the review of its annual report.

Other operational limits are characteristic to the ICS:

✓ The ICS would not protect an entity from the impact of such situations that are difficult to predict.

✓ The executive of the specific ICS procedures is a person with his own subjective peculiarities and motivation to act (the possibility to bypass the controls, negligent performance of the control procedures, incorrect understanding of instructions).

These objectively existing operational limitations to the ICS should be taken into consideration as they are developed and evaluated. Otherwise the efficiency of the planned control operations may be much lower than planned initially. This condition alone proves that the issues related to the development of ICS are not simple. Many different factors and conditions need to be taken into account here. Therefore, in the situation of each individual entity the types of controls available and their sequence should be used creatively by keeping the peculiarities of the size of the entity, type of business and personnel within the scope of attention.

Checklist for Subject 6:

1. ***Explain the meaning of the internal control system in the business activities of the enterprise.***
2. ***What are the components of internal control system?***
3. ***What does the term 'activity-integrated control procedures' mean?***
4. ***According to which general and sub-goals the internal control system is built?***
5. ***What is the underlying principle of the internal control system and how it is expressed in the performance of the different operations of an entity?***
6. ***Explain in what way the establishment of a new internal control differs from the improvement of the internal control system of a functioning entity?***
7. ***What are the types of safeguarding the entity's assets and how the control procedures can be technically performed?***
8. ***What considerations should be followed by the manager of an entity when planning the improvement of an internal control system?***

Practical assignment – either from the experience of the enterprises or other sources of information give 3 successful and 3 unsuccessful examples of internal control measures

Subject 7

Implementation of internal control system in various business cycles

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7.1. Internal control in the procurement cycle

7.1.1. Objective and significance of procurement

The procurement or purchasing cycle as an independent cycle of business transactions may include the following transaction systems:

- purchase of goods and services;
- payments for the goods and services received;
- preparation of claims and returning the goods to the supplier;
- payroll calculations;
- payment of salaries.

By separating individual business cycles of homogenous transactions, they may cover a larger or a smaller amount of transactions. Therefore the cycles of the same type may differ in two different entities. For the same reason, in the goods and services procurement cycle provided in the LR CM Regulations more transaction systems are included than are reviewed in this section. The sequence of the logical activities can be identified in a simpler and more accurate way if the cycle is more homogenous, i.e., if it includes only one type of transactions. In the procurement cycle the first and the third of the above mentioned systems should be included:

✓ purchase of goods and services;
✓ preparation of claims and returning the goods to the supplier.

The transaction system named ‘payments for goods and services received’ is discussed in the finance and accounting cycle, while the transaction systems ‘payroll calculations’ and ‘payment of salaries’ – under the human resources and social insurance issues.

The following activities correspond to the system for purchase of goods and services:

- identification of the required types of goods and services;

- ordering of goods;
- receipt, inspection and acceptance of goods (checking of items, quantities and quality as per the delivery note and the purchase order; entering of the actual data in the goods receipt document or a special note for receipt goods and material values and the confirmation of these data by signature);
- storage and realisation of goods;
- presentation in the accounting system (in accordance with the vendor invoices matched with the delivery documents and the documents on the receipt of goods, verification of the correctness of amounts before posting).

Objective of procurement is to ensure a cost-effective supply of the enterprise with goods and services in compliance with the quality and supply service terms and conditions.

The concept 'supply service' means the use of vendor services in minimising the overall procurement costs. Therefore, in procurement it is important not only to supply the exact goods and materials in the required quantity and quality at the lowest possible price. It is important also to know how to use the vendor service in streamlining the internal processes, for example, in order to ensure the delivery just at the location of demand, prepare invoices by locations were costs are incurred by thus reducing the costs of inventory storage and accounting.

7.1.2. Organisation and competence

Creation of the procurement policy or development of instructions for procurement transaction processes is an important internal control objective. Procurement policy includes:

- ✓ organisation of the procurement work in an entity – the place of the respective structural unit or employees in the organisational structure of the entity;
- ✓ characteristics of the degree of centralisation or decentralisation;
- ✓ setting of borders of competence for the procurement unit;
- ✓ operating instructions for the purchase of goods or services;
- ✓ compliance with the principles of segregation of duties and 'the four eye' principle.

The main pre-conditions for the performance of the procurement tasks is a purposeful inclusion of the procurement department in the overall organisational structure of the entity and the appropriate place for the procurement department manager in the hierarchy of this structure. By choosing whether a procurement unit should be established also some individual employees can be used for the performance of these tasks; one must consider the degree of variety, frequency and amount of the material values and services.

The instructions of the procurement transactions must indicate what purchase transactions will be carried out in a centralised and which ones – in a decentralised way. This means that according to the instructions included in the procurement policy it is possible to identify which procurement transactions must be performed by the procurement department and which ones are left at the discretion of the requesting unit.

The issue of the degree of centralisation or decentralisation of procurement depends on the situation and different other conditions. In order to supply the same product (item of goods, materials) to several requesting units in different locations it is more cost-effective to carry out this task in a centralised way when the market position is volatile (varying suppliers). While if the market is constant, then by signing contracts on certain supply terms and conditions this job can be entrusted either to the warehouses or the requesting unit. How many transactions can be left to the requesting units depends on the significance of this procurement transaction. If the purchase is of a large value 'the four eye' principle should be taken into account and this task should not be entrusted to any of the structural units, but instead specialists should be contracted who are capable of evaluating the technical and specific peculiarities of the asset unit to be purchased. If the purchase is not material in terms of its value, the involvement of the central procurement department in the procurement work can incur such an amount of total procurement costs that would exceed the expected results. The issues of centralisation and decentralisation should be addressed also in situations when there is specific market expertise available and if that can significantly affect decision making.

> Example *A wood-processing firm has enterprises in three towns. These enterprises use the wood of birch, spruce and oak trees. Supply takes place in a centralised by delivering approximately equal proportions of materials in all three towns. In one of these towns the opening of a new hotel is planned where the owners have planned to install furniture made from the oak-tree. This information has been taken as the basis for the decision to supply extra oak-tree materials by the wood-processing workshop in a decentralised way in order to manufacture the furniture requested by the hotel.*

In the Western countries where the enterprise branches are located across several countries this market research (marketing) is a very important activity particularly for the designing of a proper centralisation and decentralisation of the procurement activity.

Competence of procurement department is also defined in the procurement cycle ICS instructions. These issues are defined in part by stating the degree of centralisation and decentralisation. However, by taking into account that the procurement policy constantly needs to be updated, also special terms and assignments may be included, which are transferred to the competence of the procurement department. For example, there may be a situation when disposal of fixed assets is transferred to the competence of the procurement department which is not the direct responsibility of this unit.

By stating the borders of competence, it shouldn't be ignored that the execution of procurement tasks is related also to other structural units (finance, human resources, communication, logistics departments and the travel office). A considerably large amount of the tasks of the procurement department is channelled to these special units as part of the purchasing operations (receipt of loans, recruitment of personnel, provision of communications and transport services) is a component of the functions of these departments. The organisation of the procurement process in all cases is largely similar.

The most important components of ICS in the procurement cycle are as follows: 'the four eye' principle, inclusion of tenders in the organisation of labour, completeness of documentation, segregation of duties; these principles are all valid for the performance and control of the procurement department tasks and those assigned to other departments. Still 'the four eye' principle would be better complied with if the performance of the procurement functions is split between the procurement department and the requesting unit than if the execution of the procurement tasks is left solely upon the requesting unit itself. Likewise the decision incorporated in the instructions regarding the degree of centralisation should be constantly reviewed. It is the responsibility of the internal audit service to check whether the segregation of competence is being complied with. Procurement department should always know when and in what amount the assignment of the procurement tasks to other departments takes place.

7.1.3. Internal control in the execution of procurement transactions

In any enterprise there is a constant need for the use of some material values or services. To be able to receive them a certain procedure of formal activities should be performed which are described in procurement policy or a set of operating instructions. The process starts by ordering. The order should not be issued without a written and a properly authorised document – the completion of a purchase requisition (see Figure 7.1). It is required also in the situation when the purchase requisition is sent via electronic communication means, computer network or a modem. Thus it is ensured that each requisition is prepared or at least signed by the person in charge which is in the best position to estimate the quantity and time of ordering. In case of a written request the procurement department verifies the authenticity of the signature to exclude a possibility that materials or services are ordered by employees without authorisation for the activity.

In the procurement department a current (relevant for the respective time period) list of those persons to whom the rights have been given to make orders, besides, the area of activities within which this person can act must be indicated – a limited authorisation. Authorisations can be differentiated also by the value of purchases. Establishing the borders of competence in large entities it is not effective if the executives of the entity deal with the provision of small requisitions themselves. Of course, the possibility to transfer the responsibility to other departments and employees cannot be fully excluded and similarly it would often be necessary to make compromises to relieve the day-to-day activities during very tense periods of operations. However, at the same time an eye should be kept on the credibility of the employees authorised to perform the procurement transactions and the process of performance of the most important transactions. There are a lot of options available for the application of an extra control procedure.

The next stage in the process of procurement operations is the definition of the range of offered goods and services. Procurement should not start acting only when a certain requisition is received. The market research is a mandatory component of procurement operations. All auxiliary means should be used for the performance of this activity (radio, television, periodicals, specialised magazines and newspapers etc.). It is necessary to build good business contacts with the suppliers, also with those with whom the relationship in the form of day-to-day orders is not established. Frequency and intensity of market research depends on the value of the product to be purchased and the strategic role in the activities of an entity.

In order to choose the suppliers-to-be and at the same time to comply with 'the four eye' principle the postulate of 'a fair tender' must be adhered to. The limiting criteria that reduce the range of potential suppliers, for example, the key suppliers, mutual business transaction partners etc. must be highly justifiable. In the procedure of tender the potential suppliers are evaluated in team with the ordering entity by taking into account all decisive parameters (price, quality, safety, service).

These criteria may change by the product ordered, but they should be realistic. After the tender announcement receipt of vendor bids follows (see Figure 7.1). All bids that do not differ widely from the order limit defined by the entity should be submitted in a written form. Otherwise it would be impossible to prove the process of vendor selection. If the market situation is such that the value of all bids would exceed the value estimated by the entity, the number of bids received within a tender should be higher. A mandatory requirement for the ICS in this respect is to determine how old the bids can be and thus achieving that the bids are current and correspond to the needs of the entity.

S U P P L I E R S

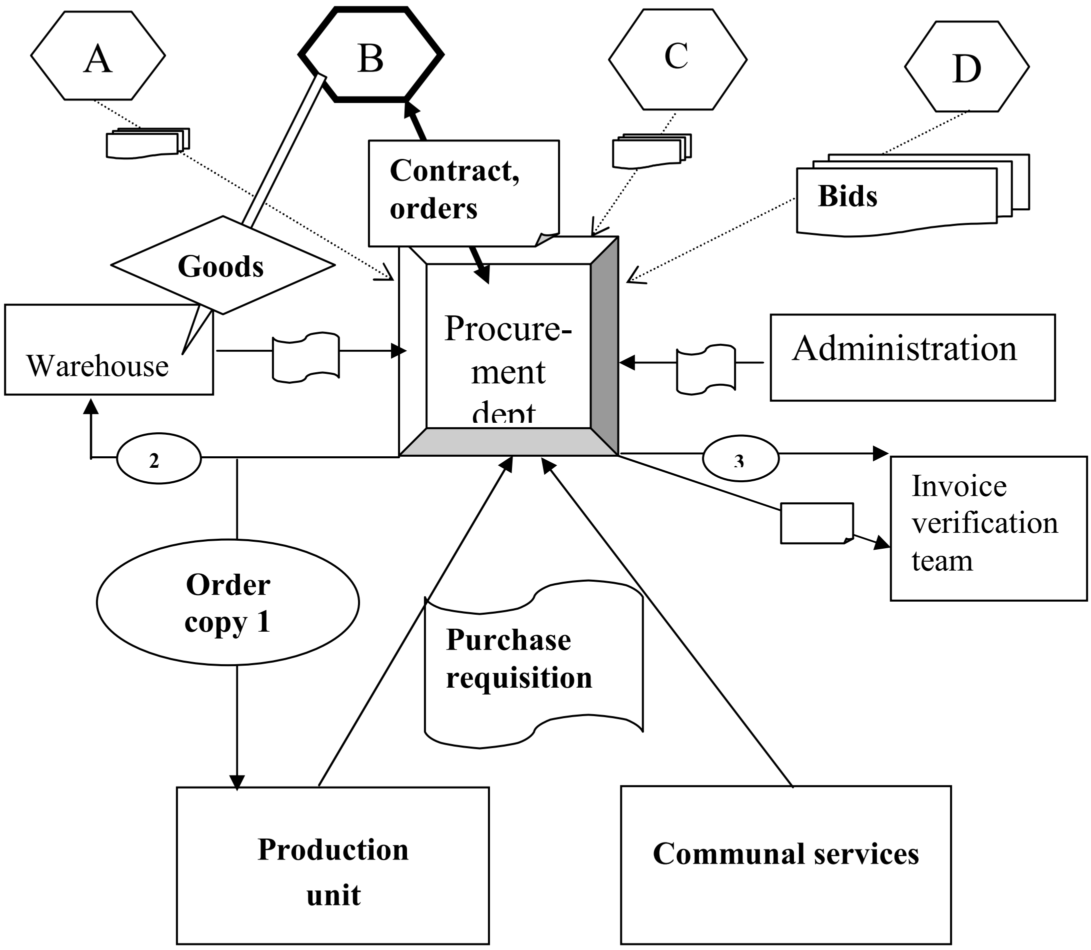

Figure 7.1. Procedure and documentation of procurement cycle operations

In case of a pro-forma contract signed for a year or longer there is no need to collect bids for each order and to arrange for a tender. But also in these situations the market situation should be constantly monitored to prepare well for the negotiation of a new contract or modification of the old one. Until the designated term of bid acceptance the information on the offers received should not be disclosed.

Not only the prices, but also other conditions are important in comparing the bids. If the price is fixed the payment terms, delivery and other extra costs can be important as well as the delivery of samples free-of-charge and the issue of guarantees. One of the requirements for ICS is to ensure that the adopted decision is verifiable. This means that the information on all offers should be found in one place, best of all in the procurement department arranged according to an index. It is necessary to prepare a written statement of all bids received. This document is particularly important for reviewing at a later stage.

The tender commission by doing the evaluation and selection of suppliers must take different factors into consideration, while many of them can only be described by qualitative measures, although they play the decisive role upon taking the decision on acceptance or rejection of the bid (for example, credibility, reliability regarding the delivery terms, relationships of mutual transactions, management of the potential order in the case of a supply in the long term etc.). In this aspect, it is difficult to review the decision making process at a later stage, therefore, the justification for taking one or another decision must be documented on the spot by approving it with the signatures of the authorised persons. Consequently, every decision represents the specific circumstances and prevents the procurement process from becoming a routine where decision-taking is associated only with the execution of formal procedures.

There is a contract signed with one of the suppliers as a result of the tender where both parties have stipulated the delivery terms. However, apart from this the procurement department prepares a written order to the supplier prior to each delivery. It may seem that this is only a scrupulous formal procedure, but the preparation of this document enables the provision of information to other structural units. A copy of the order is forwarded to at least three recipients:

- ✓ warehouse – by informing of the quantity and time of the goods to be received;
- ✓ requesting structural unit - to communicate the procurement schedule to the unit and enable the planning the rhythm of activities;
- ✓ the invoice verification team that with the help of this copy will verify the legal and substantial aspects of the vendor invoice received later (see Figure 7.1).

All orders must be signed by the authorised persons or without those signatures if prepared electronically. For the last option it must be ensured that the preparation of the order can only be performed by an authorised person included in the list of authorised personnel differentiated by the value of order. The practice where all orders are arranged in a proper order by date is considered to be an impeccable procurement labour organisation. In case of any changes such arrangement could be of assistance when negotiating the price as the argumentation of the supplier may change also over time, therefore order date can be very significant here.

A similar order should be adhered to also for the necessary changes in orders. If the terms of an unfinished business transaction should be changed the same actions must be taken as in the case of a new order, i.e., the approval of changes in a written form, signing by an authorised person or to prepare the respective changes to the order electronically and send the information to the relevant structural units. However, even making of changes to the order should not be transformed into mechanical operations as changes in one of the terms of delivery may affect others:

- ✓ if the amount of order needs to be increased the opportunity arises to negotiate a price reduction;
- ✓ if the supplier raises the price or imposes other conditions unfavourable to the purchaser, it is the obligation of the procurement department to make effort to maintain the old terms and conditions in force or to obtain other benefits. Also in case of a failure these changes in the requirements of the supplier should be documented so that for the next time a contract is signed there are materials at the disposal of the procurement department about the vendor price management and a substantiation for a possible rejection of the bid.

The next stage of the procurement activity is the order supervision. First of all this is related to the supervision of the delivery terms. This activity starts with the reconciliation of the contracts as approved by the customer and by the supplier to be able to react in case of any disagreements. In the next stage of the supervisory activity the procurement department is guided mainly by the information from the warehouse and the recipients of goods and services. To prevent from incidents when the supplier is sent a reminder of a delivery that has been already received the information system must be well-designed and efficient. For the purposes of cost reduction it is possible to make exceptions in respect of those customers the credibility of which is reliable and proven. On the other hand, procurement must notify both the requesting structural unit and the employees performing the distribution of materials as well as to the warehouse about any delays in deliveries or violations of the delivery schedule.

Also further processing of completed orders belongs to the order supervision activity. Procurement department employees do not participate directly in the inspection of the material values received as they would not necessarily have the expertise required. However, procurement receives reclamations and quality control reports from the warehouse. Detailed ICS prescriptions should be included in the procurement instructions on how the receipt and quality control of material values should be performed as well as how to perform the verification of invoices received from the suppliers.

Verification of invoices must be fully independent from the procurement process. The most careful compliance with the prescriptions for the ICS and the instructions in processing of requisitions, collection of bids, selection of suppliers and preparation of orders is pointless if invoices are verified by the procurement department. Then the principle of segregation of duties is not complied with. Verification of invoices should be entrusted to a neutral employee, best from the accounts department. The invoice verification team at the accounts or finance department or as a completely independent unit is established if the number of incoming invoices is sufficiently large. The procurement department employees are only involved in the invoice verification team if an inconsistency is found between the order and the invoice that must be clarified with the supplier. If these inconsistencies have occurred in the result of changes in the terms and conditions, procurement either makes an effort to reject, cancel or recognise them by processing this in a written form. Some such inconsistencies can be given as an example:

- ✓ lower amount of supply which exceeds the tolerable limits of deviation;
- ✓ higher amount of supply the reason for which is a price that is lower than the one specified in the order;
- ✓ premature delivery of goods which are not yet necessary – the amount of stock in warehouse increases and the interest expenses are growing as there are additional cash resources required to cover for the working capital;
- ✓ the requisite data are missing in the invoice making a sequential, ongoing invoice processing and verification impossible.

7.1.4. Summary of primary formal and organisational requirements

Filing and archiving

During all stages of procurement complete filing of documents must be ensured. Documentation must be processed and arranged in such a manner that any independent, but knowledgeable third party could get a reliable view on the individual stages of the procurement process.

Collecting and centralised storage of documents Computers should be used in archiving of documents. For this purpose, unification of documents is required.

Segregation of duties and 'the four eye' principle

In small and medium-sized enterprises a centralised receipt of goods and materials must be organisationally segregated from the procurement process. In larger enterprises the procurement operations can be performed by an independent structural unit, while the goods receipt operations can be entrusted to a team which is subordinated to the procurement department but is comparatively independent.

Verification of invoices should by no means be in the competence of the procurement department. It is recommended to transfer these functions to the accounts department.

Orders and purchasing of material values should be in the competence of different employees in order to exclude the possibility to manipulate in private interests with the amount and timing of the order as well as with the choice of the supplier.

7.2. Internal control in the sales cycle

7.2.1. Policies of the sales cycle

The sales cycle is the most important of all business cycles, as the enterprise operating results depend on its efficiency. Therefore, the set of the ICS instructions of should be prepared with particular care and the internal audit service should regularly test the degree of compliance with them.

The principles underlying the sales cycle remain the same as before: develop the policy of sales as a set of instructions of the service and create a good quality information system that would make a good basis for the adoption of management decisions.

The sales policy is developed according to pre-established entity terms, based on reliable information, can be flexibly applied to external and internal conditions and is being controlled. ICS should operate in the sales cycle so as to comply with the regulations and prescriptions defined in the sales cycle policy, and therefore, in the most important operational stages such control procedures should be 'incorporated' that would direct the human operation to the fulfilment of these prescriptions and would concurrently serve as a warning system by pointing out at the deviations from them.

Internal control has many forms in the sales cycle. The specific control measures are primarily based on the distribution of competence and the correct application of the information available.

Distribution of competence In establishing the distribution of competence among employees of the sales department the whole list of key areas of the sales cycle should be covered. Among the main here are the following:

- types of sales (wholesale, retail sale);
- pricing policies;
- policy regarding quantities (the possible amounts of stock-building for selling to customers);
- customer service (delivery service);
- quality of goods.

Under each one of them the respective job descriptions must be designed, but it should be noted that the borders of competence are drawn here not only by the vertical and horizontal segregation of duties within the hierarchy structure, but the differing long-term and short-term responsibility imposed on every employee must be considered as critical. This means that the competence of the employees working in the same area of competence, for example, in the pricing policy area will differ mainly by splitting the transactions by terms - one of them will take care of the proper use of the prices for the production already adopted (short-term responsibility), while another will make the research and estimates for a correct calculation of prices for the production to be sold in a shorter or longer future (long-term responsibility).

Information system as the basis for internal control is based here on the statistical figures starting from the stage of receiving orders till its completion and post-processing. Upon electronic processing of the sales transactions it is possible to group and to sort the data by different attributes. The type and scope of analysis depends on the size and the area in which an entity operates. Key areas of statistics and analysis are as follows:

- sales statistics (products, customers);
- statistics of sales and distribution costs;
- analysis of the structure of products sold;
- analysis of the customer structure.

Product sales statistics provides information about which of the products has contributed to the respective amount of sales. The customer movement statistics – represents the composition of customers. By combining these two types the product –

customer statistics is acquired enabling to find out how many customers by buying one and the same product constitute the respective amount of sales. The customer movement statistics presents the variances in the basic composition of customers. It is likewise possible to see, how many and which customers have moved from one sales class to another within a certain period of time. It is also possible to acquire analysis about new customers and the decrease in sales. For a full analysis of the sales cycle the statistical data by groups of products, industries and regions referring to the global information should be supplemented with the statistical data about the employees sent on business trips. The last could be necessary to calculate the fulfilment of the plan in respect of sales revenue per employee.

Planning of ***sales and distribution cost statistics*** is a highly important component of planning of cost-effectiveness of sales. This includes the following data analysis:

- ✓ transport vehicles and roads;
- ✓ packing materials;
- ✓ customer service;
- ✓ warehouse management;
- ✓ costs of business trips;
- ✓ bids submitted and orders received.

Evaluations regularly performed from such positions are useful for short-term sales management. For development of long-term strategy a more detailed analysis is required. A special role here is played by the analysis of the product and customer composition.

Within the framework of the ***product composition analysis*** the products are broken down by sales classes, and within the classes a further breakdown is made in view of all specific product-related costs. Thus the sales strategy relevant to each product is acquired: whether it's sale should be continued with positive results or to wait for more favourable conditions, or to reject the idea of selling this product at all. The last conclusion is based on the fact that products with a small amount of sales have unusually high production, purchase and selling costs which in some cases are not added according to their measurement. It is useful to supplement the product composition analysis with the calculation of the production costs by performing the measurement of fixed and variable costs as well as the amount of contribution of the product.

Customer composition analysis is carried out to calculate the outcome of sales per each customer. This is not an easy thing to do as it is necessary to summarise and calculate the costs associated with each customer. Classification of sales attributable to the customers as well as the data for the purchase and production cost analysis should be collected from all affiliates of the entity. In order to perform the customer composition analysis according to the total of the data acquired those customers are identified that provide either positive or negative sales results.

By summarising the above a conclusion has to be made that the most important instruments for the operation of ICS in the sales cycle policy are as follows:

- evident regulation of competence and making its enhancement by authorisation of users and their respective signatory rights;
- evaluation of the individual orders to examine irregularity;
- preliminary processing of sales information with the purpose of identifying the weaknesses in the structure (range of goods, range of customers, distribution channels, business trips).

7.2.2. Pricing

The importance of pricing in the sales cycle should not be underestimated as it is very often the case when the business outcome of an entity depends on how properly this work is performed. Therefore, the following issues are current for the internal control system in the area of pricing:

1) Who takes decisions on prices and quality?
2) How reliable is the substantiation for decision making?
3) How to ensure that the prices would not be set incorrectly?

(1) It is clear that pricing and quality assurance in an entity should be adjustable. Usually the liability for pricing lies with the executives at the top level of the entity's hierarchy. If several structural units participate in the decision taking process the borders of competence should be laid down in a written form. The organisational form for adoption of decisions regarding prices and quality may be either centralised or decentralised. Still regardless of the form these should be oriented to the market demands (the prices should be flexible) and the internal peculiarities of the entity (employee qualifications, computerisation, rational labour organisation). Use of information on pricing for certain purposes and free access to it should be defined by means of segregation of competence. The use of this information should be permitted and transferred only to those employees holding the respective authorisations for the adoption of decisions on the issues of pricing. It is usually assumed that the information on pricing by hierarchy levels is transferred to the employees in the form of pricelists, but the direct use of the data on calculation of prices and costs is restricted. If the calculations are done

by computers, the ICS provides for an access to the cost information at various levels of detail only upon special permissions and passwords.

(2) Correct calculations are at the basis of pricing. Calculations of prices for each product are necessary if the market price is not available. The basis for such calculation is the full production cost and the profit margin characteristic for the particular group of products by therefore arriving at the selling price. The price calculation is as if ahead of the possible rise in the costs for the period until the moment of sale. Computerised calculations therefore should prepare the data on the expected future costs where the costs of materials should be measured by prices of the purchases made last, while the production costs – by recalculating the capacity utilisation of the actual equipment into normal capacity utilisation. Normal capacity utilisation of the equipment excludes the frequent changes in the production costs, and therefore, the basis for price measurement does not vary continuously. This means it is assumed that a lower capacity utilisation of the equipment represents an extraordinary situation which cannot serve as the scale in the transaction measurement. However, if the capacity utilisation of the equipment remains low for a longer period of time, higher production costs should be included in pricing. Due to the peculiarities of the entity a multi-level contribution amount estimate may appear in the calculation of the variable production costs. By calculating the price from the point of view of the final cost the production costs of a single level should be calculated. Otherwise, if the production costs are incorrectly split into the costs of materials and labour by assessing also the fixed and the variable costs, this may lead to an incorrect outcome, and therefore – also to the wrong price.

(3) In order to secure against incorrect pricing in individual sales transactions, ICS provides a pricing and quality control. Sales prices can be verified in several ways:

- ✓ 'fixed' price for a certain product;
- ✓ individual price on each order;
- ✓ price for a certain combination – customer/product;
- ✓ price layers for specific products, corresponding to the customer and the discount applied to the customer.

The pricing control procedures can be technically executed both automatically, i.e., with the help of a computer, and manually. In the latter case no automatic control is possible as the price is not set; however, it is possible to perform the price reliability test by comparing it to the existing amount of production costs. In this option for pricing 'the four eye' principle should be strictly observed to avoid the influence of the personal interests of any employees on the pricing process.

Other forms of pricing may be combined in such a way that the computerised system for execution of orders finds the required price amount in a hierarchical order. First of all, it checks whether there is a price set in respect of a product to be supplied to a certain customer; if the system does not find it the search is checking whether the customer should not be given a discount and the respective price range. If this is not found either, the execution of the order takes place at a 'fixed' price taken from the pricelists. In the situation of such automated price management it should be programmed that all changes in prices and quality are being documented. Regular submission of the statement of changes to the persons in charge allows them perform the control functions.
Manual control in those cases should be performed in a centralised manner or else performed by employees in charge for the financial performance results of the entity. If upon review of the execution of order any variances in prices or quality are found or if regardless of the automatic pricing system it is necessary to use special operational rules, these should be clearly and unambiguously worded in the operating instructions. Besides, it should be followed that the segregation of competence in pricing is maintained and the transfer of execution of the possible order to centralised structural units is strictly documented and the financial performance report submitted to the employee in charge. The pricing and quality control organised in this way should be completed with the testing of the estimate period. This contains the preparation of the document where the following data are presented for each product:

- ✓ gross profit;
- ✓ the lowest, medium and the highest price;
- ✓ reduction in revenues by each product due to the application of discounts.

7.2.3. Sequence and internal control of order fulfilment

Completion of the order received by the supplier from buyer is associated with a certain procedure of activities including also various control procedures. In comparison with the procurement cycle, these activities take place in supplier's entity where the ICS implementation policy is a described order for a correct procedure of processing and control of information related to any sales transaction. The application of the segregation of duties principle in sales cycle is expressed as <u>the segregation of the order processing functions from dispatching to the buyer which, on its turn, is segregated from the posting</u>

of a completed order. Therefore, we will also discuss the requirements for ICS in a certain order, individually for each stage of the sales cycle.

Order processing takes place immediately after receipt, but also here several steps can be distinguished (see Figure 7.2).

Step 1 – purchase order registration. The order is received either in a written or in a verbal form, besides it can be placed by a representative of the entity or commanded employee both in the affiliate of sales, the sales department, the central order processing unit or in some cases at the executive office. Any order must be registered immediately after receipt regardless of whether it will be completed or not. An order can be received in completed form as well as directly from the customer through data transmission devices (modem, computer network etc.). It is critical that all most important data are recorded at an early stage and stored in a database in an organised form.

Step 2 – input control. After the receipt of an order it must undergo the input control where the issues related to the feasibility of the fulfilment of the order are clarified. For the performance of those operations the following information is necessary:

- ✓ availability of the goods to be dispatched;
- ✓ numerical feasibility;
- ✓ creditworthiness of the customer;
- ✓ quality compliance of the product to the sales policy.

The said tests can be performed automatically by using the computer systems. Special rules take effect if the order does not pass the input control without problems: for example, the specification of the desired product is not included in the master data, the credit limit has been exceeded or there are no such goods in the warehouse.

Availability and numerical feasibility of the goods for dispatching First of all the input control verifies whether the order can be physically met by identifying if the goods for supply are found in the warehouse and in sufficient quantity compared to what is indicated in the order. If this is not the case, it is important to coordinate the delivery date of the customer with the options available to the entity. The finished products or goods warehouse communicates the possible delivery term to the sales department in due time. If the order cannot be met from the goods currently located in the warehouse the sales department orders the goods from the procurement department. Coordination of the amount and the schedule of the order takes place within entity. Purchase of goods should take place following the same principles as purchase of consumables and raw materials. If the enterprise is short of own production the sales and production departments coordinate the production plan by taking into consideration the priorities for deliveries as well as the product manufacturing time. Often the urgent orders for production or procurement departments evidence an incorrect labour organisation in the enterprise.

Creditworthiness of the customer Before the order is processed further it is necessary to receive the credit control authorisation from the accounts department. In case of computerised information processing credit control is integrated in the order processing system. Information about the credit limit set by the enterprise, any debts overdue and outstanding of the specific customer as well as about a possible blocking of the customer account are obtained here.

If no such database is available it is recommended to prepare the list of critical customers which the accounts department submits to the sales department. This list must contain updated information about the following:

- ✓ amount of the claims;
- ✓ any debts overdue and outstanding;
- ✓ any reminders sent and the following responses from the customer;
- ✓ customers to whom no deliveries should be made before the execution of payments.

Generally the main issues of credit control are related to division of customers into new and old customers by particularly distinguishing the critical customers as well as to setting of appropriate credit limit amounts and compliance with these limits in sales transactions. It is highly important that credit control is linked with the required level of competence. ICS should foresee in what situations credit control must be coordinated with the issues under the competence of the sales department manager, and when – with the competence of the enterprise management or any other top hierarchy level employee.

Quality compliance with the sales policy is the conclusive task in order processing. If it is not designed that each order undergoes price and quality control prior to execution other controls should be applied. One of such instruments could be the preparation of a list in which those orders with variances from normal sales quality requirements are presented. Then a separate decision is taken regarding the capability to fulfil this order.

In the course of execution of the order safety measures should be used to exclude the possibility to make any unauthorised changes in the order data (application of a free-of-charge delivery, price alterations) after the order has been registered.

A written confirmation of order completion is sent to the customer always when any changes in the price, delivery terms or quality are necessary for the fulfilment of order.

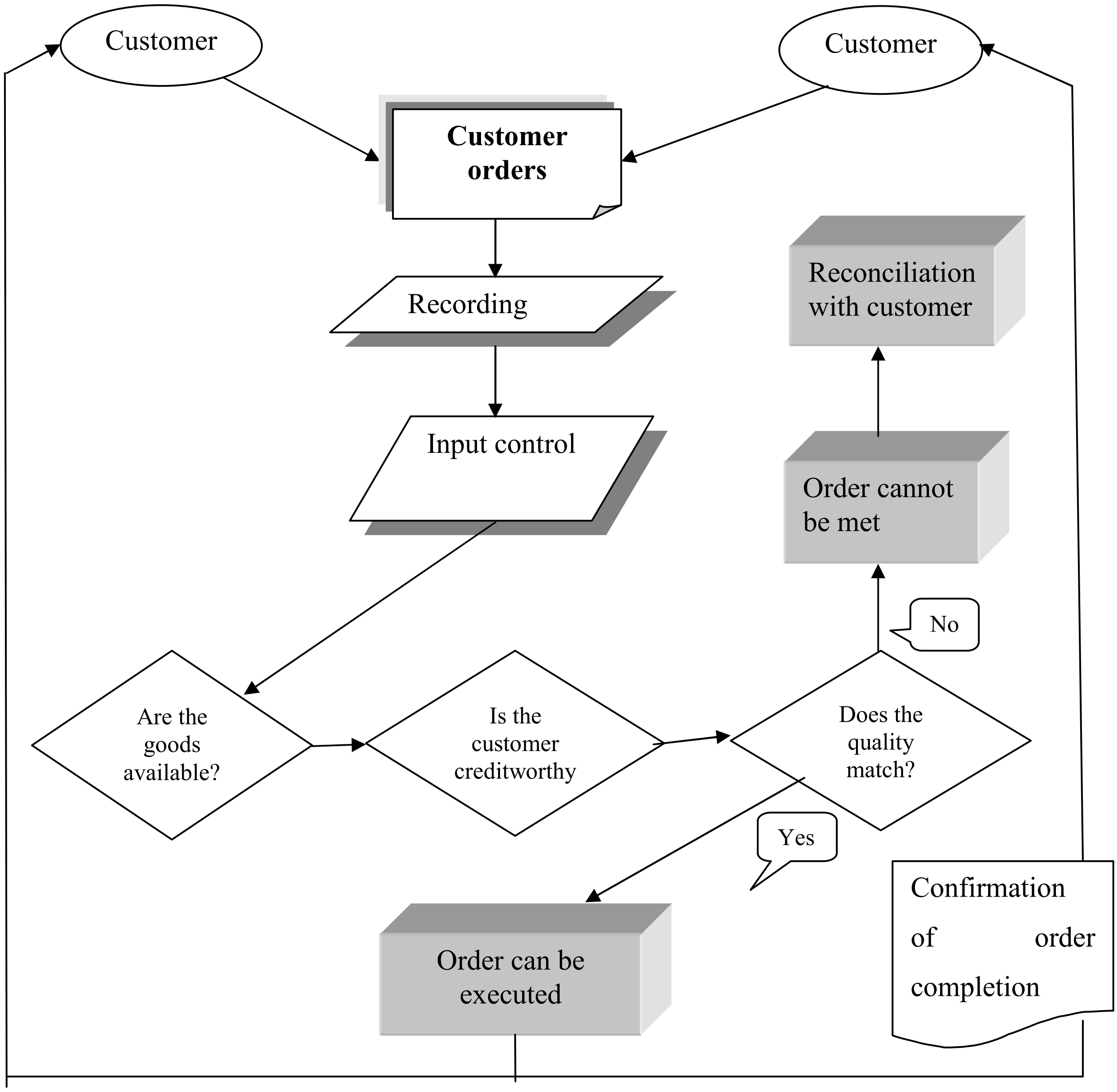

Figure 7.2. Processing of customer orders within the sales cycle

In other cases the preparation of such a document may not bear an informative meaning.

Dispatching of goods is rather independent from processing of orders. This should be carried out according to the delivery term which is communicated both to warehouse and transport department and to production units in due time. Only in case of an ongoing coordination it is possible to avoid urgent orders increasing sales and distribution costs. Dispatching of goods is confirmed with the goods delivery notes and other documents related to the movement of the goods from supplier to buyer, including authorisation to take goods out of the enterprise territory. Only if these documents are complete and are correctly prepared any control of the goods movement can be done. Dispatcher of the entity of buyer submits the authorisation for the receipt of goods and the sales department prepares three copies of a goods delivery note then to be signed and sealed by accounts department. An authorised representative of buyer signs the second copy of the note and gives it to the person in charge as a confirmation on receipt of goods. This document then serves as the justification for the accounts department to make the necessary accounts receivable entries and record the respective reduction in the stock of goods in warehouse. Therefore, in the dispatching stage the actual movement of material values must be subject to control, on the one hand; information processing and storage – on the other.

During the third stage of the sales cycle **posting** of the sales transaction takes place. This means that in order to account for sales correctly it is necessary to ensure the compliance with certain ICS principles. If during the stage of dispatching the goods in certain cases a pro-forma invoice is issued together with the documents for dispatching of goods it is necessary to ensure that for all delivery notes there is a matching pro-forma invoice issued and posted. The numbered forms of pro-forma invoices combine the attributes of both types of documents therefore the above requirement is met automatically. It should be likewise provided that in the process of invoice issuing and posting the possibility of a manual intervention is excluded in the result of which the reversal of some data or other changes might be necessary on already completed orders.

7.2.4. The most important control procedures of the sales cycle

Summarising the above, if internal control procedures are properly applied in sales cycle, the ICS requirements meet its sub-goals. Most critical ones are described below.

1. Ensure that sales amount includes real supplies to real customers (***existence*** sub-goal).

Procedures:

a) sales amounts confirmed by authorised transport docs as per customer order;

b) numbered pro-forma invoices, then the accounting is performed;

c) monthly reports are sent to customers to reconcile the amount of debt.

2. Verify if the sales operations are properly authorised (the sub-goal of ***authorisation***).

Procedures: Special or general authorisation must be provided in most significant cases:

a) upon taking the decision for the sale of goods on credit to a customer;

b) by issuing the order for dispatching the goods;

c) upon adoption of decisions in the area of the pricing policy.

3. Completeness check (the sub-goal of ***completeness***).

Procedures:

a) transport docs (delivery notes, consignment slips) numbered and registered;

b) pro-forma invoices are numbered.

4. Reconciling the amount of goods dispatched to registered amount (***accuracy*** sub-goal).

Procedures:

a) instructions for the completion and accounting of pro-forma invoice;

b) verify if the correct accounts have been used for postings;

c) use a chart of accounts suitable for the operations;

d) administrative checks.

5. Test if transactions are accurately and timely recorded in ledger accounts (***accuracy***).

Procedures:

a) the procedure for recording of transactions should be provided for in the instructions by defining the respective time limits;

b) segregation of duties by making the necessary entries in the sales journal and the statement of accounts receivable;

c) sending of monthly reports to customers;

d) administrative checks.

6. Provide for the security of the asset items and information (***safeguarding of assets***).

Procedures: security, safe deposits, passwords etc. physical safety measures.

Checklist for Subject 7:

1. ***Policy development is a significant component of every internal control cycle. What is included in the policy of the procurement or purchasing cycle?***
2. ***How the purchasing procedures should be realised in the ideal case and what documents are required to authorise the transactions?***
3. ***How is the principle of segregation of duties realised in the procurement cycle?***
4. ***What is the significance for collecting and analysis of information on sales transactions and the assignment of competence to the employees in sales cycle?***
5. ***Which internal control procedures are recommended for execution of customer orders?***
6. ***What are the main risks incurred in this business cycle?***
7. ***What are the individual issues for which it is critical to assign special authorisations to employees?***

Practical assignment – identification of internal control errors and the development of appropriate new control procedures in the analysis of various situations in real life

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Appendix

Practical Assignment

'Preparation of Working Documents for Auditing of Purchasing System and Preliminary Assessment of Internal Control'

Exercise 1

1) Prepare the plan of an audit assignment
   a) Consider what approach you would choose in order to carry out the first interview with the director of the training centre and to motivate the employees of the audit service. What problems do you foresee and how would you deal with them?
   b) Prepare the audit assignment project by indicating the audit objectives, main system objectives, audit scope as well as the necessary resources. Prepare an overview of the system in an appropriate format. Highlight those areas to which special attention needs to be devoted by substantiating your choice. What is the expected audit outcome and who will be the beneficiaries?
   c) Make a note about what further information you would need to be able to plan and perform the audit.

2. Make an assessment of the system
   a) Prove your assessment of the system and prepare a more detailed description in which the respective processes and areas of interrelation are indicated and described. **Prepare the *flowchart* of the system audited.**
   b) Identify and consider in detail the main control objective of control as well as the main risk factors, issues and concerns.
   c) Consider what further information and actions are necessary to approve the audit plan and to close the fact finding stage to proceed with the main priority issues.

3. ***Complete the working paper 'Action plan for the audit assignment'*** (see the forms below the case study)

4. Identify and assess the control environment and the main control mechanisms – ***complete the working paper 'Internal audit programme'***
   a) Assuming that you have gained sufficient knowledge of the system and its main aspects prepare the preliminary opinion of the main control measures as a whole.
   b) Taking into account all other facts identify the specific areas in which a substantial audit should be performed.
   c) Choose (by substantiating your choice) one of the areas and consider it as a sub-process, business issue or control task by assessing the main control measures, considering specific risk factors and control objectives.
   d) As far as possible develop your first opinion on the adequacy of control in the area selected by recording your opinion in the Internal Audit Programme.
   e) Consider the next steps: possible tests, reports to management and proposals for the improvement of control.

5. Consider the testing strategy and specific tests
   a) Prepare a list of questions to be asked as well as of items to be considered before carrying out the tests.

b) Decide what compliance or substantive tests you would carry out in those areas which you consider critically important, fundamental or weak.

<u>6. What else should be done to complete the audit and to fulfil the audit objective?</u>

Consider the issues that you would include in your report and how you would present your findings, conclusions and recommendations. ***Prepare the preliminary version of the working paper 'Schedule for implementation of recommendations'.***

(Use the forms for completion of the exercise, if possible.)

2. Case Study

1. A few years ago at a training centre 'The Future' was opened at one of the higher educational establishments with the purpose of providing training courses on various topics of public administration. Pro-rector Mr. Zariņš is responsible for the operation of the centre within the establishment.
2. The centre was opened outside the capital city by remodelling a complex of buildings of a rural farm. Director of the centre Mr. Pušmucāns, who believes that the centre has the prospects for becoming a leader in its area of activity. High-quality courses are offered by the centre and scientific research carried out. The financing is composed of the study fees from the customers of the services provided, the EU project financing as well as in part from the state budget. The vision for development provides that within ten years the centre should pass on to self-financing. Currently negligible income is received by renting premises to other organisations.
3. In the preceding year the amount of expenses constituted EUR 6.8 mln, of which 10% were financed from the state budget. Also the realisation of a capital investment scheme worth EUR 900,000 is started.
4. There are 22 trainers employed in the centre, of which some are the former tutors of other higher educational establishments, 16 are administrative and 3 – technical staff. Also the visiting tutors and external consultants are invited to do the training. The centre owns a car and a minivan. In the preceding year several new upgraded computers have been installed, but in the forthcoming year it is planned to provide all employees and training rooms with personal computers, install a fully integrated network and introduce the computer conferencing equipment.
5. Structurally centre consists of 7 units 6 of which are faculties: finance and accounts, information systems, management, policy development, raising of finance, business studies, and one - an administrative unit which is managed by Mr. Lapiņš and subordinated to the director of the centre. Mr. Lapiņš is 58 years of age former civil servant. The structural unit managed by him performs the functions of a secretary office, makes all the administrative and financial arrangements, including accounting, budget control, supply, security, payroll, human resources as well as provides internal services associated with the support and management of the training process.
6. Centre has several rooms for conferences and workshops, sports hall and dormitory. There is also a bar and a canteen with 150 seats. Director of canteen Mrs. Lēniņa is in charge of everything necessary for the provision of catering. Officially her position is included in the administrative unit, while in practice she works independently. The centre also has a small library, but it is still in the process of development.

3. Further information for completion of exercise

1. The internal audit unit of the higher educational establishment plans to carry out the audit of the training centre. It has not been audited so far. You are the team manager in charge for the execution of this audit. Partially the information given in the description of the case study is contained in the audit file, while other information has been provided by the junior auditor entrusted to carry out the preliminary survey. (The rest of the information that is available will be provided further in the text).
2. Junior auditor during the preliminary survey found that the director of the centre has a strong character and is rather intolerant to external audits, according to him. He treats sceptically the statement by auditor that they came to help. He indicated, however, that they would need some assistance in the development of new procedures, obtaining of additional financing and equipment as well as for the solution of some communication problems with certain employees. When the auditor explained that these areas were not included in the scope of audit he did not seem to be pleased.
3. Having understood that this would not be an easy audit, the audit team manager takes the decision to reduce the audit scope and initially do the audit of procurement alone.
4. The administrative unit (AU) is in charge of all supplies and purchases for the training centre, except for catering. Internal procedures are still being developed, but the current faculty directors are authorised to make small orders to suppliers. Other deliveries are processed in AU with the use of internal requisition documents.
5. For the purchase of some items with the value exceeding EUR 3,500 an authorisation from the director of the centre is necessary. During his absence this authorisation may be issued by the director of any other unit. If the purchase value exceeds EUR 15,000 an authorisation from the higher educational establishment is necessary.
6. AU employee Mr. Ziedonis Ziediņš is in charge of the receiving supply requisitions, the authorisation of certain orders, negotiating the supply contracts as well as for the approval of payments for the goods received. Mr. Ziediņš also collects information from the faculties on the receipt of the goods ordered. He is assisted by Mr. Niklāvs Kurmis, who is in charge of the day-to-day processing of requisitions and orders.
7. There is a central procurement department in higher educational establishment where the centre is founded centrally ordering specific items (stationery, toilet paper etc. items) included in List A. Other special purpose goods (items for the training needs – List B) are being ordered by the training centre itself. There is an agreement that the centre would pass the orders of List A to the central procurement department of the higher educational establishment. All other items (also those attributable to List B) the centre orders directly from the suppliers, based on the contracts signed.
8. Upon the receipt of an internal requisition document Mr. Ziediņš either completes the supply document which is sent to the central procurement department or the order document which is sent to the suppliers as a requisition to supply the specified goods.
9. Director of the canteen Mrs. Lēniņa is personally dealing with all supplies of goods. The orders are based on a weekly menu.
10. It is included in the functions of AU that all faculties notify Mr. Ziediņš upon receipt of goods. Then he communicates this to AU accounts team which then provides acceptance for execution of payments for invoices received. The invoices designated by codes are sent to the financial department of the higher educational establishment.
11. All faculties must keep ledgers of a certain format on all materials and equipment in use. Stock-takes of fixed assets are not carried out.
12. AU is not preparing any formal reports. Overviews of monthly expenditure showing the actual versus budgeted costs are prepared by the Finance Department of the higher educational establishment and sent to the centre.
13. Mr. Ziediņš is a Member of the Chamber of Commerce and believes that he is therefore in a better position to choose the suppliers.

14. The AU director Mr. Lapiņš keeps an indexed catalogue of instructions including also the amendments to the approved list of suppliers.
15. Certain batches of goods supplied the centre stores in the central warehouse of the higher educational establishment, while some batches are delivered straight to the centre. The functions of the warehouse manager are performed by Mr. Ziediņš. If no other addressee is indicated the invoices received at the centre are forwarded to Mr. Ziediņš by the secretary office.
16. Centre has a EUR 3,000 budget for small or unexpected local purchases and charges.
17. The manager of the AU department has the information that the higher educational establishment has hired a new Finance Director who is sceptical about the plan for decentralisation of the budgeting process for the training centre. He therefore wishes that a full audit is performed on those budget transactions in which the centre is involved and to receive a report next week.
18. Mr. Ziediņš is on a sickness leave for three weeks. His duties have been taken over by an employee from the accounting team. He was unable to find certain accounting entries and documents or to reconcile certain amounts.
19. The director of AU has approved the purchase of 6 personal computers based on individual orders, EUR 3,000 each.
20. Accounting entries show that in the previous 6 months expenses have grown largely.
21. The audit team manager has just held a conversation with the director of AU. The centre director enters after a while and informs of his suspicion about Mr. Ziediņš. He asks to examine this matter in more detail. He does not have any direct evidence, but it seems that the audit team manager has somehow referred to Mr. Ziediņš and wishes to receive the necessary evidence. In conclusion he adds that the auditors should know something about the director of AU Mr. Lapiņš and the director Mrs. Lēniņa...

4. Conclusions by auditor

1. During the review of invoices paid for the previous 6 months the following is found:
    - regular payments to firm 'Marika&Co' which is a well-known retail outlet group supplying goods like furniture, equipment, devices (including kettles and laundry washing machines) and as stated in the invoice – 'for exquisite confectionery';
    - an invoice for EUR 25,000 from 'Riga Light' for the supply and installation of a hot-house on instruction by Mr. Pušmucāns;
    - EUR 7,000 has been paid in advance to a Norwegian software designing enterprise for the development and supply of a remote conferencing system.
2. Budget for the previous year was overspent partially due to the following reasons:
    - travelling, household and representation expenses – 75% above the plan;
    - an error in payroll planning, where the employment of two new full-time employees has not been taken into account;
    - unexpected (and obviously unauthorised, too) overdue payments to the canteen employees that may have been necessary for holding of a ceremonial lunch attended by high-ranking officials upon participation also by the top executives of the centre together with their spouses (at minimum cost);
    - higher inflation for certain equipment items than expected (to some extent this is compensated by the reduction in the prices for computers and software).
    3. Top executives were aware of the existence of such consumption, but not about their nature and reasons, and have not taken any measures.
    4. The protocol indicates that two months before the end of the previous year the director of the centre Mr. Pušmucāns has convinced the Pro-rector in charge of

the higher educational establishment Mr. Zariņš that the actual expenditure would exceed the budgeted by EUR 75,000 only.

5. One of the auditors has a suspicion that certain income and expense items have been misrepresented as capital, but he is not sure about it.
6. Consultants have developed the internal finance management system worth EUR 200,000. This does contradicts the approach of the central Finance Department of the higher educational establishment. This was not announced in advance, and it is believed that own system could be used. Mr. Pušmucāns is of a different opinion. The director of AU Mr. Lapiņš is uncertain about this issue and clearly feels that he should retire. The new system does not operate yet.
7. Expenses to external consultants have grown by 42% over the last 6 months while for visitor tutors they grew by 60%. According to the estimates of the auditors the consumption by the end of the current financial year will reach 17.6%.
8. An invoice for external catering is EUR 1,245 for serving a buffet held during the visit of training consultants. Some bottles of wine cost EUR 50 and more.
9. Expenses for foreign trips and business trips exceed EUR 70,000 in the current year. There is no evidence of organised control that would ensure that all business trips have been authorised and that the advances issued have been reported and recorded. Mr. Pušmucāns and his secretary have been on several business trips. On one of the business trips to Stockholm he was accompanied by Mrs. Lēniņa.
10. Additional employees have been hired based on the possible income from currency exchange differences in the future. Auditors have not taken this aspect into account, but they were told that the overall number of employees had decreased. Still there is no doubt that the centre has a well-established reputation as the provider of high-quality courses.
11. It may be concluded that the director of AU and other employees of this unit are frequent visitors to the golf field located not far from the training centre.
12. The budget in the centre is not appropriated based on the operations of the units. The amount of the item 'Miscellaneous' constitutes 5% of the budget.
13. It is planned to introduce the new finance management system within 6 months. This is according to Mr. Lapiņš, but he is not in charge and does not know who is.
14. Last week the centre ran out of toilet paper.
15. Mr. Ziediņš declines any responsibility for stock in the warehouse.
16. Auditors have not checked cash on hand and any amounts of petty cash issued. They have started to think whether that was right.
17. One of the invoices is for dog food.
18. The dates indicated on the orders for the 6 computers are the same and they are issued for identical computers.
19. Auditors confirm that the food for lunch is great.
20. There has not been any time left for a review of the following:
    - expenditure for research;
    - accuracy of the stock take;
    - items included in List A.

5. Sample working paper forms

Action plan of an internal audit assignment

Audit title	
Audit reference number	
Total number of days allocated for the audit	
Expected draft report preparation date	
Auditor	Signature _______ Date ______
Internal audit unit manager	Signature _______ Date ______
Objective of the system **Control objectives**	
Audit objective	
Comments	

APPROVED BY

____
(State Secretary or Director of Entity)

____
(date)

Schedule for implementation of internal audit recommendations

Ref. No.	Recommendation	Priority of recommendation	Implementa tion date	Official in charge

Internal audit unit manager

(full name and signature) (date)

Internal auditor

(full name and signature) (date)

Manager of the audited unit or entity

(full name and signature) (date)

Internal audit programme

SYSTEM SUB-SYSTEM Page

Ref. No. ________
Control objective ____

Scope of internal auditing				Assessment of internal control	
Main risk factors	Necessary control	Necessary control assessment	Method of testing	Reference	Assessment of control
1	2	3	4	5	6
Risks present in the achievement of objectives	Control reducing the effects of risk	Preliminary control assessment by auditor	What tests are performed to assess the control efficiency	Evidence from the audit file	Findings, assessment and recommendations after tests of control

Prepared by ____
(full name and signature of the auditor)

Reviewed by ____
(full name and signature of audit uanager)