

Practice Advisory 2120-2 Managing the Risk of the Internal Audit Activity

Primary Related Standard

2120 – Risk Management

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

Interpretation:

Determining whether risk management processes are effective is a judgment resulting from internal auditor's assessment that:

- *Organizational objectives support and align with the organization's mission.*
- *Significant risks are identified and assessed.*
- *Appropriate risk responses are selected that align risks with the organization's risk appetite.*
- *Relevant risk information is captured and communicated in a timely manner across the organization, enabling staff, management, and the board to carry out their responsibilities.*

Risk management processes are monitored through ongoing management activities, separate evaluations, or both.

1. The role and importance of internal auditing has grown tremendously and the expectations of key stakeholders (e.g., board, executive management) continue to expand. Internal audit activities have broad mandates to cover financial, operational, information technology, legal/regulatory, and strategic risks. At the same time, many internal audit activities face challenges related to the availability of qualified personnel in the global labor markets, increased compensation costs, and high demand for specialized resources (e.g., information systems, fraud, derivatives, taxes). The combination of these factors results in a high level of risk for an internal audit activity. As a result, chief audit executives (CAE) need to consider the risks related to their internal audit activities and the achievement of their objectives.
2. The internal audit activity is not immune to risks. It needs to take the necessary steps to ensure that it is managing its own risks.
3. Risks to internal audit activities fall into three broad categories: audit failure, false assurance, and reputation risks. The following discussion highlights the key attributes related to these risks and some steps an internal audit activity may consider to better manage them.
4. Every organization will experience control breakdowns. Often times when controls fail or frauds occur, someone will ask: "*Where were the internal auditors?*" The internal audit activity could be a contributing factor due to:
 - *Not following the International Standards for the Professional Practice of Internal Auditing.*

- An inappropriate quality assurance and improvement program (Standard 1300), including procedures to monitor auditor independence and objectivity.
 - Lack of an effective risk assessment process to identify key audit areas during the strategic risk assessment, as well as areas of high risk during the planning of individual audits – as a result, failure to do the right audits and/or time wasted on the wrong audits.
 - Failure to design effective internal audit procedures to test the “real” risks and the right controls.
 - Failure to evaluate both the design adequacy and the control effectiveness as part of internal audit procedures.
 - Use of audit teams that do not have the appropriate level of competence based on experience or knowledge of high risk areas.
 - Failure to exercise heightened professional skepticism and extended internal audit procedures related to findings or control deficiencies.
 - Failure of adequate internal audit supervision.
 - Making the wrong decision when there was some evidence of fraud – e.g., “It’s probably not material” or “We don’t have the time or resources to deal with this issue.”
 - Failure to communicate suspicions to the right people.
 - Failure to report adequately.
5. Internal audit failures may not only be embarrassing for internal audit activities, but they can also expose an organization to significant risk. While there is no absolute assurance that audit failures will not occur, an internal audit activity can implement the following practices to mitigate such risk:
- Quality Assurance and Improvement Program: It is critical for every internal audit activity to implement an effective quality assurance and improvement program.
 - Periodic Review of the Audit Universe: Review the methodology to determine the completeness of the audit universe by routinely evaluating the organization’s dynamic risk profile.
 - Periodic Review of the Audit Plan: Review the current audit plan to assess which assignments may be of higher risk. By “flagging” the higher risk assignments, management of the internal audit activity has better visibility and may spend more time understanding the approach to the critical assignments.
 - Effective Planning: There is no substitute for effective audit planning. A thorough planning process that includes updating relevant facts about the client and the performance of an effective risk assessment can significantly reduce the risks of audit failure. In addition, understanding the scope of the assignment and the internal audit procedures to be performed are important elements of the planning process, which will reduce the risks of audit failure. Building internal audit activity management checkpoints into the process and obtaining approval of any deviation from the agreed-upon plan is also key.
 - Effective Audit Design: In most cases, a fair amount of time is spent understanding and analyzing the design of the system of internal controls to determine whether it provides adequate control prior to the start of testing for effectiveness. This provides a firm basis for internal audit comments that address root causes, which can sometimes be the result of poor control design, rather than addressing symptoms. It will also reduce the chance for audit failure by identifying missing controls.
 - Effective Management Review and Escalation Procedures: Internal audit management’s involvement in the internal audit process (i.e., before the report draft) plays an important

part in mitigating the risk of audit failure. This involvement might include work paper reviews, 'real-time' discussions related to findings or a closing meeting. By including management of the internal audit activity in the internal audit process, potential issues may be identified and assessed earlier in the assignment. In addition, an internal audit activity may have guidance procedures outlining when and what types of issues to escalate to which level of internal auditing management.

- Proper Resource Allocation: It is important to assign the right staff to each internal audit engagement. It is especially important when planning a higher risk or a very technical engagement. Making sure the appropriate competencies are available on the team can play a significant role in reducing the risk of audit failure. In addition to the right competencies, it is important to ensure the appropriate level of experience is on the team, including strong project management skills for those leading an internal audit engagement.
6. An internal audit activity may unknowingly provide some level of false assurance. "False assurance" is a level of confidence or assurance based on perceptions or assumptions rather than fact. In many cases, the mere fact that the internal audit activity is involved in a matter may create some level of false assurance.
 7. The use of internal audit resources in assisting the organization to identify and evaluate significant exposures to risk needs to be clearly defined for projects other than internal audits. For example, an internal audit activity was asked by a business unit to provide some "resources" to assist with the implementation of a new enterprise-wide computer system. The business unit deployed these resources to support some of the testing of the new system. Subsequent to the deployment, an error in the design of the system resulted in a restatement of the financial statements. When asked how this happened, the business unit responded by saying that the internal audit activity had been involved in the process and had not identified the matter. Internal auditor's involvement created a level of false assurance that was not consistent with its actual role in the project.
 8. While there is no way to mitigate all of the risk of false assurance, an internal audit activity can proactively manage its risk in this area. Frequent and clear communication is a key strategy to manage false assurance. Other leading practices include:
 - Proactively communicate the role and the mandate of the internal audit activity to the audit committee, senior management, and other key stakeholders.
 - Clearly communicate what is covered in the risk assessment, internal audit plan and internal audit engagement. Also explicitly communicate what is not in the scope of the risk assessment and internal audit plan.
 - Have a "project acceptance" process to assess the level of risk related to each project and internal audit's role in the project. The assessment may consider: the scope of the project; the role of the internal audit activity; the reporting expectations; the competencies required; and the independence of internal auditors.
 - If internal auditors are used to augment the staffing of a project or initiative, document their role and scope of their involvement, as well as future objectivity and independence issues rather than using internal auditors as 'loaned' resources, which may create false assurance.

9. The credible reputation of an internal audit activity is an essential part of its effectiveness. Internal audit activities that are viewed with high regard are able to attract talented professionals and are highly valued by their organizations. Maintaining a strong “brand” is paramount to the internal audit activities’ success and ability to contribute to the organization. In most cases, the internal audit activity’s brand has been built over several years through consistent, high quality work. Unfortunately, this brand can be destroyed instantly by one high-profile, adverse event.
10. For example, an internal audit activity could be highly regarded with several of the key financial executives having had rotational assignments as internal auditors, which was viewed as a training ground for future executives. A string of significant re-statements and regulatory investigations, however, would impact the reputation of the internal audit activity. The audit committee and the board might ask if the internal audit activity has the right talent and quality assurance and improvement program to support the organization.
11. In another example, during an audit of the human resource function, the internal auditors may discover that background checks were not being reviewed appropriately. The discovery that newly hired internal auditors did not have the appropriate education background, while others had been involved in criminal activity, could seriously impact the credibility of the internal audit activity.
12. Situations like these are not only embarrassing, but they also damage the efficacy of the internal audit activity. Protecting the reputation and the “brand” of the internal audit activity is important not only to the internal audit activity, but to the entire organization. It is important that internal audit activities consider what types of risks it faces that could impact its reputation and develop mitigation strategies to address these risks.
13. Some practices include:
 - Implement a strong quality assurance and improvement program over all processes in the internal audit activity, including human resources and hiring.
 - Periodically perform a risk assessment for the internal audit activity to identify potential risks that might impact its “brand”.
 - Re-enforce code of conduct and ethical behavior standards, including The IIA’s Code of Ethics to internal auditors.
 - Ensure that the internal audit activity is in compliance with all applicable company policies and practices.
14. To the extent that an internal audit activity experiences an event outlined above, the CAE needs to review the nature of the event and gain an understanding of the root causes. This analysis provides insight into the potential changes to be considered in the internal audit process or control environment to mitigate future occurrences.
