

2012 CHANGES TO THE GLOBAL INTERNAL AUDIT STANDARDS

SIX THINGS
AUDIT COMMITTEES AND CHIEF AUDITORS
NEED TO KNOW

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Leading Practices in Audit, Risk & Assurance

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SUMMARY

Six key areas

Used in the right way
can increase internal
audit's effectiveness

Organisations which
get in early will yield
benefits

In October 2012 the Institute of Internal Auditors (IIA) released their latest revisions to their global standards. These standards come into effect from 1 January 2013.

The IIA's global standards board have held global webinars to give insights not only into what was written, but what their thinking was at the time. As a former member of the IIA's Global Professional Practices Council and protagonist of some of these changes, we were very keen to understand some of the subtleties in what has changed and why.

Our assessment is that while at first glance many of the changes appear to be semantic word changes, there are six key areas that chief auditors and audit committees will want to be across.

In this brief we provide a summary of each issue, together with our interpretation and actions that organisations can and should take now to comply while also getting more out of their internal audit function.

SIX KEY AREAS FOR CHIEF AUDITORS AND AUDIT COMMITTEES

1. Organisational independence
2. Assessment of compliance with IIA standards
3. Quarterly updates to the internal audit plan
4. Acceptance of risks
5. Strategic risk
6. Internal audit opinions

BEYOND CONFORMANCE

Historically IIA Standards have tended to lag better practices.

IIA's accelerated refresh cycle means their suggestions are increasingly reflective of contemporary practice, and in fact, useful.

We recommend clients get on the front foot and use these changes as an impetus to improve the effectiveness of their internal audit functions.

I

ORGANISATIONAL INDEPENDENCE

In the October 2012 revision, the IIA has added two tests of organisational independence of the internal audit function.

This list has now caught up with our previous advice to clients and provides audit committees with an objective basis for assessing the function's independence.

The full list is now as follows:

Organizational independence is effectively achieved when the chief audit executive reports functionally to the board. Examples of functional reporting to the board involve the board:

- *Approving the internal audit charter;*
- *Approving the risk based internal audit plan;*
- *Approving the internal audit budget and resource plan;*
- *Receiving communications from the chief audit executive on the internal audit activity's performance relative to its plan and other matters;*
- *Approving decisions regarding the appointment and removal of the chief audit executive;*
- *Approving the remuneration of the chief audit executive; and*
- *Making appropriate inquiries of management and the chief audit executive to determine whether there are inappropriate scope or resource limitations.*

WHAT YOU SHOULD BE DOING

1. Chief auditors should assess themselves against the current criteria, and engage early with their audit committee and executive sponsors to discuss any gaps.
2. Audit committees should also require their internal audit function to be assessed against criteria set out in standard 1110 (listed above) and for this to be reviewed annually.

While now the norm, some of these matters can be controversial. We have assisted a range of clients through this process and would be happy to assist or provide a briefing.



ASSESSMENT AGAINST IIA STANDARDS

While there is now fairly universal endorsement of the IIA's standards, many internal audit functions have not reflected the last two rounds of changes or had an assessment since these changes went through.

Many also have never had an assessment and hence gaps are likely.

Given that IIA now updates its standards every 1-2 years, regular self-assessment is needed if audit committees want to be comfortable with their internal audit function.

WHAT YOU SHOULD BE DOING

1. Internal audit functions should assess themselves against the specific wording in the 2012 revisions.
2. Audit committees should also ask for their internal audit function to assess itself against the IIA standards and report status to them at least every two years. They should also ask for this to be independently verified at least every five years.

We have helped chief auditors to proactively assess themselves against the standards, to develop and embed a quality program, manage file quality and to prepare for independent validation. If you need any assistance in any of these areas, please give us a call.

3

QUARTERLY AUDIT PLAN REFRESH

The rate of organisational change has increased and continues to do so.

In this context, static audit plans are a good starting point but regular reconfirmation / refresh of the audit plan is now expected. IIA standards board members are now suggesting that quarterly is their preferred option.

New wording is as follows:

The chief audit executive must review and adjust the plan, as necessary, in response to changes in the organization's business, risks, operations, programs, systems, and controls.

WHAT YOU SHOULD BE DOING

1. Internal audit functions need to be careful not to chase risks at the expense of providing assurance or delivering the core plan.
2. Small audit shops should tread carefully before embarking on quarterly reviews of the plan as this can cause 'thrashing' at the expense of delivering the audit plan for the year. A half-year reconfirmation is more appropriate.
3. We recommend that internal audit keep an eye on "risk of control failure" – typically caused by changes in personnel, accountabilities, systems and/or processes. For more on this, read our suggestions on [heat maps for auditors](#). (hyperlink)
4. Internal audit functions should also assess whether the organisation's risk management process is up to the job, and whether management is identifying and responding to emerging risks. If this is not happening, now is the time to independently review the organisation's risk management framework. This will probably require bringing in external expertise.
5. If accountability for risk and 2nd lines of defence are not clear, internal audit should also assess this and provide a view.

If you need assistance with greater risk foresight or assessing 2nd lines of defence, please give us a call.

4

ACCEPTANCE OF RISKS

We've long had a view that once risk assessment is mature in an organisation, the role of audit can provide as a second opinion on management's assessment, rather running it's own parallel process.

A second opinion process enables internal audit to bring to management's attention places where their risk assumptions are incorrect (usually through overestimating the effectiveness of controls) and hence to provide 'management by exception'.

This is a welcome contrast to 'management by distraction' where sometimes audit can second guess priorities and cause a situation that audit reports become the 'tail that wags the dog'.

IIA has taken a small step towards this by requiring management to confirm their acceptance of the risks in the report. They have also muddied the water by blurring this with issue tracking and monitoring of actions taken.

New wording is as follows:

When the chief audit executive concludes that management has accepted a level of risk that may be unacceptable to the organization, the chief audit executive must discuss the matter with senior management. If the chief audit executive determines that the matter has not been resolved, the chief audit executive must communicate the matter to the board.

The identification of risk accepted by management may be observed through... monitoring progress on actions taken by management as a result of prior engagements, or other means.

WHAT YOU SHOULD BE DOING

1. If your internal audit report templates don't contain a placeholder for both the executive sponsor and the chief auditor to confirm that they accept the risks and actions in the report, now is a good time to start.
2. Although responsibility for resolving issues lies with management, IIA formally requires internal audit to form a view on whether identified risks are being resolved. This requires a follow up process.
3. As a better practice, we recommend that the close out should consider whether the root causes are addressed, rather than simply whether the recommendation has been implemented.

5

INCLUSION OF STRATEGIC RISK

The IIA is starting to recognise that value destruction often comes from strategic risk rather than from the traditional areas of operations, financial controls and compliance.

Alas they've confused the issue by focusing on whether the organisation has risks facing its strategic objectives. As we've been advising since 2007, this approach leads to a focus on operational rather than strategic risks.

A higher priority is whether the organisation understands and is responding to genuine strategic risks – i.e. those risks that could invalidate its current business model(s).

Our view is that this will become a requirement in the not too distant future, and is already implied in the 2007 ASX Corporate Governance Council Good Governance Recommendations.

New wording in the 2012 IIA Standards is as follows:

The internal audit activity must evaluate the adequacy and effectiveness of controls in responding to risks within the organization's governance, operations, and information systems regarding the... achievement of the organization's strategic objectives.

WHAT YOU SHOULD BE DOING

1. If your organisation has clearly stated strategic objectives, then definitely include these as part of your audit planning methodology.
2. Internal audit should leapfrog what IIA's requirements and form a view of whether the organisation understands the strategic risks facing it, and is responding appropriately.

We've done extensive work in this area, in particular to help organisations identify emerging strategic risks and blind spots, and have used this as a catalyst for developing in-house capabilities. If you need assistance in this area, or would like to know what leading organisations are doing in this space, please give us a call.

6

INTERNAL AUDIT OPINIONS

The IIA has come around to our view that report ratings, gradings and conclusions are an audit opinion, and need to be treated with appropriate due care and process.

New wording is as follows:

Engagement Opinion (definition) - The rating, conclusion, and/ or other description of results of an individual internal audit engagement, relating to those aspects within the objectives and scope of the engagement.

WHAT YOU SHOULD BE DOING

Chief auditors and audit committees should make sure that reports provide clear context, scope and identify any limitations.

We suggest reviewing your latest last batch of reports and asking three questions:

- Were the scope and objectives clear? Were they acquitted in full? Were there any limitations that the reader should be aware of?
- Is it clear what was covered, what wasn't and why?
- Do your reports contain blanket disclaimers? Do these help or hinder the reader's understanding? How could customised "reader beware" statements assist?

This area can cause difficulties for some service providers due to overlap with their professional standards and requirements by the AuASB and APESB.

We've done extensive work in this area, with particular focus on improving audit rigour, reducing audit risk and reducing unintentional reliance by readers.

We've also successfully brokered arrangements that work for the client and the firm's requirements that are 2012-compliant for IIA and AuASB standards.

If you need help in this area, please give us a call.

CONCLUSION

Historically IIA Standards have tended to lag better practices.

While they claim to be principles-based, the reality is many of the standards are mandatory, and hence require compliance or general conformance.

As the IIA now has an accelerated refresh cycle, their suggestions are increasingly reflective of contemporary practice, and while this results in the occasional ill-formed idea (such as in the area of strategic risk) in most cases are generally useful and are worth adopting.

We recommend clients get on the front foot and use these changes as an impetus to improve the effectiveness of their internal audit functions.

ABOUT THIS PUBLICATION

This is one part of a series of white papers, articles and presentations provided free of charge to our subscribers.

This is for information only, and does not constitute formal advice.

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MORE INFORMATION

Please follow the links to IIA Global's website.

[IIA Media Release – 2012 Standards](#)

[2012 IIA Standards \(free download\)](#)

ABOUT TODD DAVIES & ASSOCIATES



Todd Davies & Associates was formed to help organisations get the most out of their audit & risk functions.

We have a long track record of defining leading practices and setting new norms in internal audit, risk and assurance.

We work with organisations of all shapes and sizes to help them get the most out of their audit & risk functions and to define and implement leading practices.

Todd is supported by a team of risk and assurance experts including former chief auditors and some of the leading thinkers internationally in this space.

For more information about who we are, what we do, and who we do it with, please go to our website: www.todddavies.com.au.

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