Risk Based Internal Audit Process

Strengthening Public Financial Management Program to Enable Service Delivery (**SPFMS)**

Finance Division, Ministry of Finance

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Agenda

- Basic principles of the IA methodology

- The Internal Audit Process (IAP)

Basic Principles of the IA Methodology
Risk-Based Audit Approach
(IIA Standards:2010, 2040, 2120, 2200, 2210, 2240, 2330, 2400, 2420)

- The IA methodology is risk-based and process-oriented with the purpose of adding value to the department.

- At Ministry level:

  - A comprehensive assessment of risks is performed
  - Risk based audit plans are prepared linking risks to processes, duly considering the concerns of the PAO (Secretary) or Audit Committee (AC) and Management.
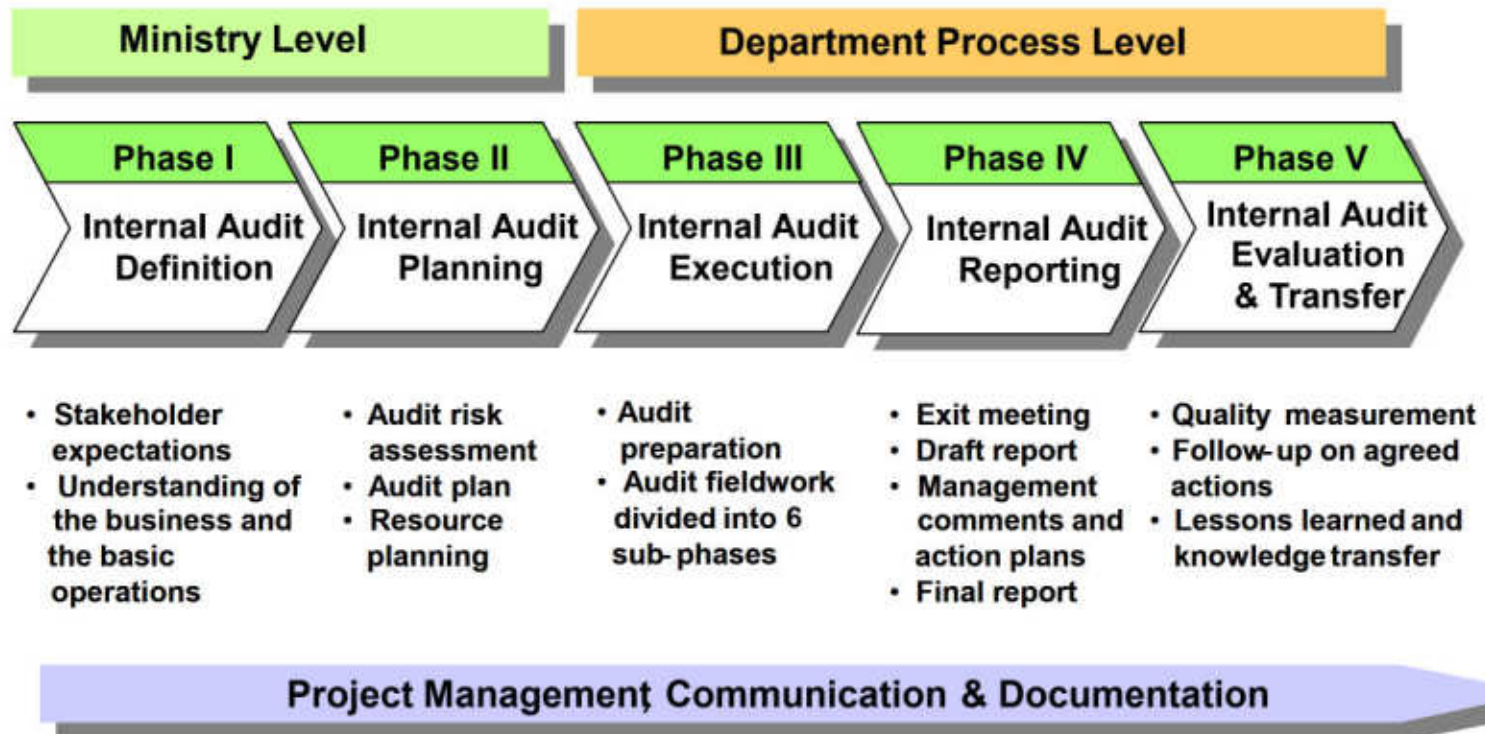
Basic Principles of the IA Methodology
Risk-Based Audit Approach

- At process level:

  ▸ A process risk assessment is performed taking into account the risk assessment at the Ministry level.

- The risk profile at the Ministry level is regularly reviewed to ensure process level risks and process audit results are duly considered and reflected in the overall audit plan (feedback loop).
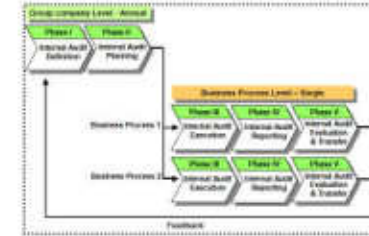
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The Internal Audit Process (IAP) Overview

The IAP methodology has been developed to best suit department needs and to provide a standard process that can be consistently applied by all local Internal Audit functions ministry wide.

It comprises 5 phases:

Ministry Level		Department Process Level		
Phase I	**Phase II**	**Phase III**	**Phase IV**	**Phase V**
Internal Audit Definition	Internal Audit Planning	Internal Audit Execution	Internal Audit Reporting	Internal Audit Evaluation & Transfer
• Stakeholder expectations • Understanding of the business and the basic operations	• Audit risk assessment • Audit plan • Resource planning	• Audit preparation • Audit fieldwork divided into 6 sub-phases	• Exit meeting • Draft report • Management comments and action plans • Final report	• Quality measurement • Follow-up on agreed actions • Lessons learned and knowledge transfer

Project Management, Communication & Documentation

The Internal Audit Process (IAP)
A Two-Level Approach (1/2)

The IAP has two levels:

▸ Ministry level

> ▸ These process phases are intended to provide an understanding of the stakeholders' expectations, ministry strategies, processes, KPI's and risks/controls (high level). This understanding is primarily used to identify processes/risks for audit planning purposes.

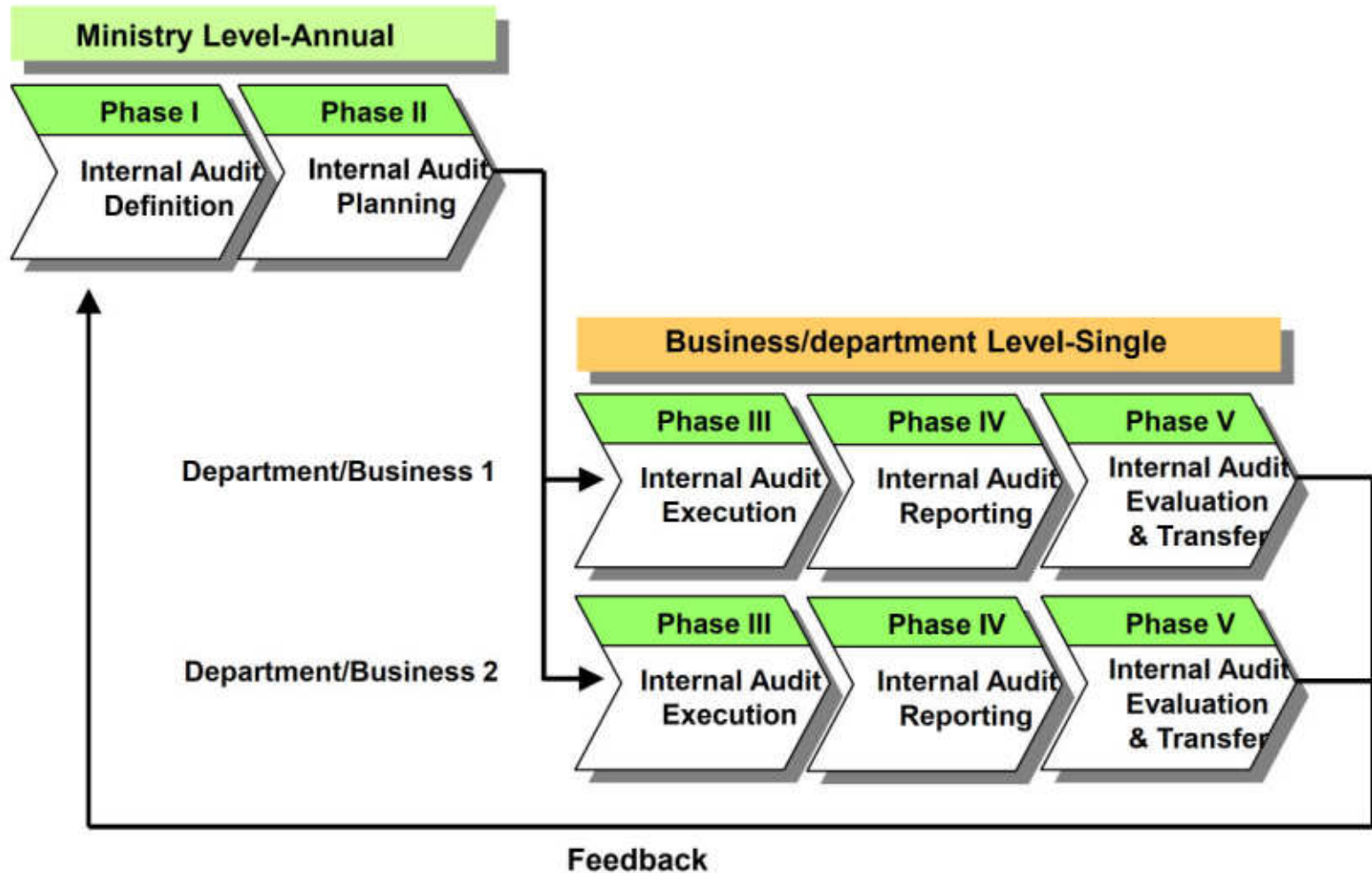> ▸ The IA definition and planning phases at Ministry level are generally performed annually.

▸ Department Process level

> ▸ This level concentrates on analyzing individual business processes. The phases included in this part relate to evaluating a specific targeted process that selected for an audit during the planning phase at Ministry level.

> ▸ The process level approach is generally performed on a project basis, i.e. for a single audit.

> Audit results are taken into account in the definition and planning phases through the feedback loop.

The IAP
A Two-Level Approach (2/2)

Ministry Level-Annual

Phase I	Phase II
Internal Audit Definition	Internal Audit Planning

Business/department Level-Single

Department/Business 1

Phase III	Phase IV	Phase V
Internal Audit Execution	Internal Audit Reporting	Internal Audit Evaluation & Transfer

Department/Business 2

Phase III	Phase IV	Phase V
Internal Audit Execution	Internal Audit Reporting	Internal Audit Evaluation & Transfer

Feedback

Audit results are taken into account in the definition and planning phases through the feedback loop.

The IAP
Advantages of the IAP

Advantages of this two-level IAP:

- ▸ Flexible IA approach
  - ▸ Consistency in audit planning
  - ▸ Ability to tailor specific process-related audits
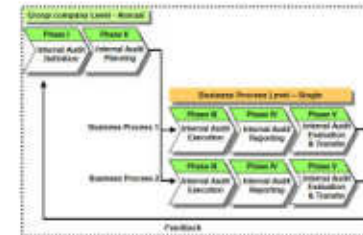
IA Planning

Combine Audit Risks, Business Processes and Locations

- Audit risks, business processes and locations should be covered according to their priority.

- IA should cover all locations over a period of 1 to 2 years (through physical visits, self-assessments or remote assessments).

- The long-term plan covers a period of 2 years and should specify: audit risks, risk description, processes, locations, priority and year of audit.

- The annual plan should specify: audit risks, processes, locations, priority, time schedule and resources employed for each audit project.

- Senior Management (and / or the PAO / AC, if applicable) should formally approve both the long-term and the annual IA plans.

IA Annual Planning

Link risks and processes to locations:

- Determine the [locations] where IA will perform an audit of selected processes in order to address the key risks identified.
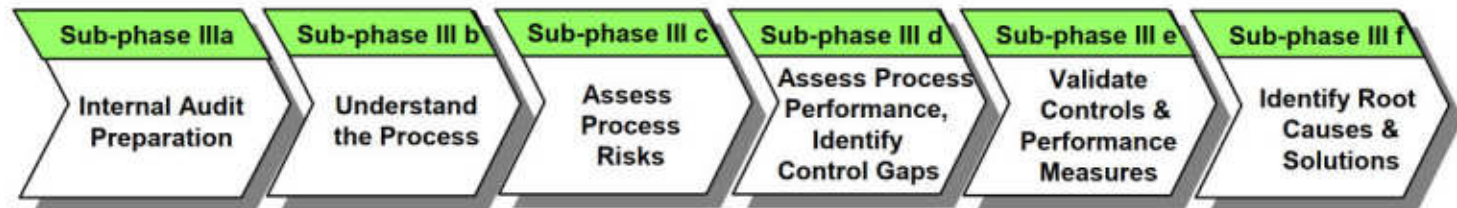
Location Risk Linkage

IA Risks	Business Processes	Location Risk Rating			
		Ministry Office (HQ)	Area Office	District A	District B
IT Security	• IT • HR • Procurement • Financial •	High High High High High	Low N/A N/A Low Medium	Medium Medium High Medium Low	Medium Medium High Medium Low
Compliance	• Financial • Procurement	Medium Medium	Medium Medium	N/A N/A	N/A N/A
Empowerment	• Procurement • Financial •	High High High	Low Medium High	High Medium Low	High Medium Low

IA Planning
Annual IA Planning

- A systematic approach is in place for planning and scheduling audit projects.

- Jobs are scheduled and planned to ensure auditors with the right competencies are assigned to the right job.

- Outsourcing should be considered if specialized skills are needed or time constraints exist.

- *Reserve time should be considered in planning **(20 to 30%)**.*

- Completion of audit plans and possible deviations are continuously monitored and communicated to Senior Management (and the AC, if applicable) and to Director IA (CAE).

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IA Execution – Overview on Steps and Deliverables

Sub-phase IIIa	Sub-phase III b	Sub-phase III c	Sub-phase III d	Sub-phase III e	Sub-phase III f
Internal Audit Preparation	Understand the Process	Assess Process Risks	Assess Process Performance, Identify Control Gaps	Validate Controls & Performance Measures	Identify Root Causes & Solutions

Steps

• Revisit IA planning documents and work programs	• Gather process information	• Identify risks in the process	• Identify controls including performance measures	• Determine type and extent of tests	• Define gaps / observations to be further analysed
• Gather and analyse current information relevant to the audit project	• Receive or draw process flowchart	• Source risks	• Evaluate design of controls and performance measures	• Design and perform tests	• Identify causes of gaps
• Interview main stakeholders	• Validate process flowchart	• Measure and prioritise risks	• Identify control gaps	• Document and analyse results	• Rate significance of gaps / observations
• Assign adequate resources and prepare work plan and budget (as applicable)		• Establish process risk list (or optionally process risk map)	• Identify "quick wins"		• Identify possible corrective action to control and performance gaps
• Co-ordinate audit schedule with auditee organisation, announce audit project		• Define risks to be analysed in detail			• Formulate observations and recommendations
• Conduct opening meeting		• Validate process risk list			• Obtain Process Owner / Management response
					• Complete field work, prepare for reporting

Deliverables

• Project file in TeamMate EWP	• Process documentation	• Interview notes	• Documentation of controls	• Documented audit test results and conclusions	• Validated and documented observations, risks and recommended actions
• Audit Work Plan and Budget	• Process flowchart	• Process risk list / map	• Assessment of control design		• Complete documentation of performed audit procedures
• Defined, documented and verified audit objectives, scope	• Interview notes	• Structure of Audit Work Program	• Analysis of process performance measures		
• Audit Approach presentation			• Documentation of control gaps and recommendations for control design		
• Minutes of opening meeting					
• Draft of introductory sections of IA Report					
• Interview notes					

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IIIa - IA Preparation - Objectives

- The objectives of the IA preparation phase are:

    - Gain a fundamental understanding of the process or function to be audited in order to determine a relevant and risk based audit objective and scope, as well as the timing, resources and budget of the planned or specially requested audit project

    - Prepare for an efficient and effective audit process up to the conclusion of the audit project (e.g. ensure availability of auditee personnel, documentation and data, set date for closing meeting, plan audit resources)

    - Inform Management, and as applicable other employees of the organisation, of the audit to be performed and of the internal audit process and methodology

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IA Preparation – Overview on Steps and Deliverables

Sub-phase IIIa	Sub-phase III b	Sub-phase III c	Sub-phase III d	Sub-phase III e	Sub-phase III f
Internal Audit Preparation	Understand the Process	Assess Process Risks	Assess Process Performance, Identify Control Gaps	Validate Controls & Performance Measures	Identify Root Causes & Solutions
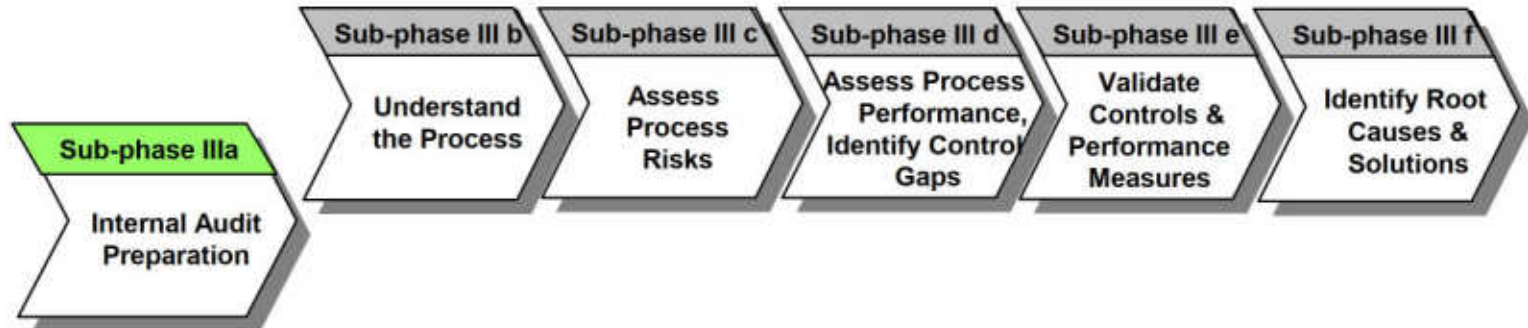
Steps

- Revisit IA planning documents and work programs

- Gather and analyze current information relevant to the audit project

- Interview main stakeholders

- Assign adequate resources and prepare budget

- Co-ordinate audit schedule with auditee organisation, announce audit project

- Conduct opening meeting

Deliverables

- Project file

- Audit Work Plan and Budget

- Defined, documented and verified audit objectives and scope

- Audit Approach presentation

- Minutes of opening meeting

- Draft of introductory sections of IA Report
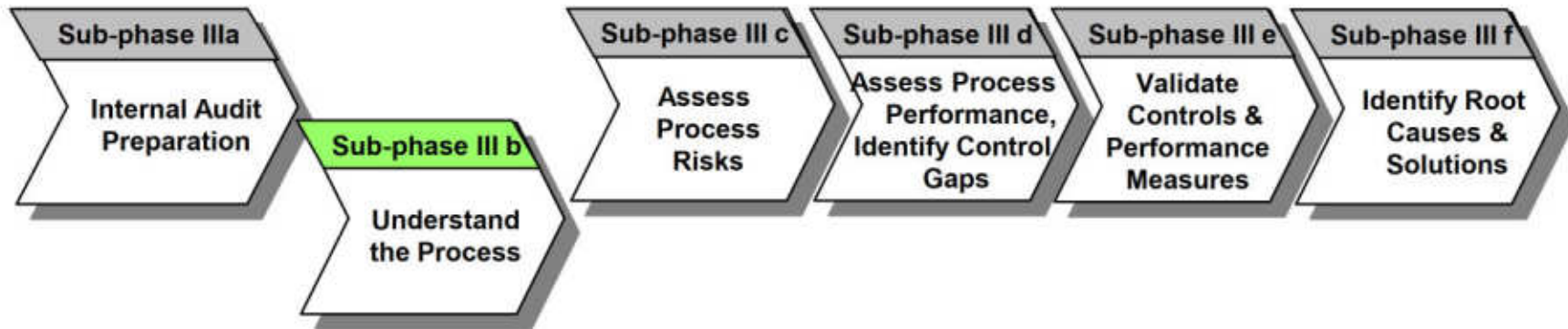
- Interview notes

IIIb - Understand the Process - Objectives

- The main objectives of the sub-phase Understand the Process are:

  - ▸ Gain a clear understanding of the process to be audited
  - ▸ Identify preliminary risk areas
  - ▸ Identify existing control points
  - ▸ Identify how process performance is measured
  - ▸ Highlight parts of the process that *appear* to be subject to high risk, are repetitive (low efficiency) or misaligned with Management's intentions (low effectiveness).

Understand the Process
Overview of Steps and Deliverables

Sub-phase IIIa	Sub-phase III b	Sub-phase III c	Sub-phase III d	Sub-phase III e	Sub-phase III f
Internal Audit Preparation	Understand the Process	Assess Process Risks	Assess Process Performance, Identify Control Gaps	Validate Controls & Performance Measures	Identify Root Causes & Solutions

Steps

- Gather process information

- Receive or draw process flowchart

- Validate process flowchart with management

Deliverables

- Process documentation
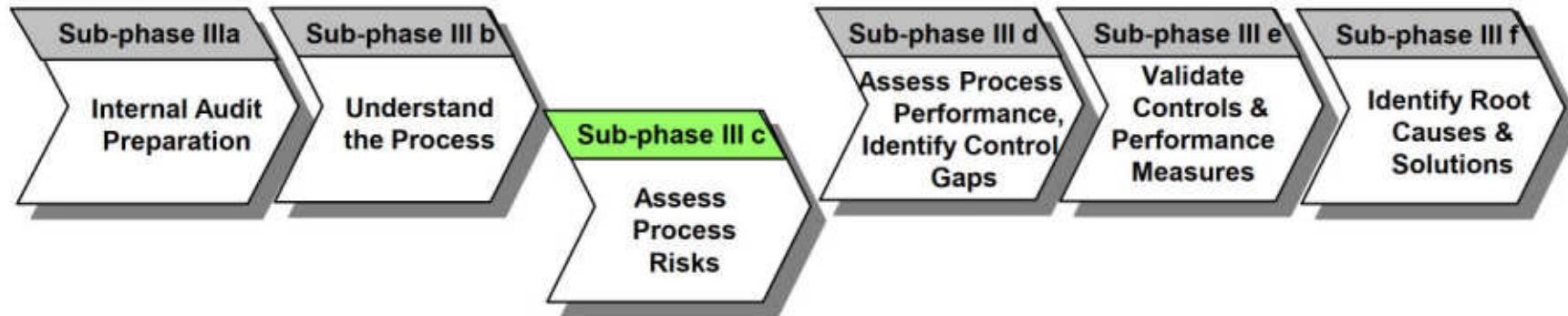
- Process flowchart

- Interview notes

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IIIc - Assess Process Risks - Objectives

- The main objectives of the sub-phase Assess Process Risks are:

  - Identify process risks ("What can go wrong? What can compromise process objectives?")
  - Measure and prioritise risks ("Which risks have potentially the highest impact?")
  - Define and document risks to be analysed in depth, and outline the Audit Work Program for the audit project

  - Note: while available work programs may give guidance in the identification of process risks, they do not relieve IA of the task of always assessing risks in the Department/Ministry specific process(es) subject to review. The risk analysis covers the entire scope for which the internal auditor will provide assurance

Assess Process Risks
Overview of Steps and Deliverables

Sub-phase IIIa	Sub-phase III b	Sub-phase III c	Sub-phase III d	Sub-phase III e	Sub-phase III f
Internal Audit Preparation	Understand the Process	Assess Process Risks	Assess Process Performance, Identify Control Gaps	Validate Controls & Performance Measures	Identify Root Causes & Solutions

Steps

- Identify risks in the process

- Source risks

- Measure and prioritise risks

- Establish Process Risk List (or optionally Process Risk Map)

- Define risks to be analyzed in detail

- Validate Process Risk List with Management

Deliverables

- Interview notes

- Process Risk List / Map

- Structure of Audit Work Program

Sample Audit Program

8	Treatment of inventory differences			
8.1	Inventory differences	**Audit Step:** - Assess relevant procedures and policies. - Assess the amount of adjustments and differences recorded and compare them to the turnover and inventory level. - Inquire if every adjustment is properly approved by an authorized person (also by verifying and reviewing the corresponding supporting documents) - Select a sample of inventory differences and verify, if they have been adjusted timely and adequately.	**Risks:** - Unauthorized inventory adjustments. - Concealment of theft or fraud.	**Controls:** **Control Objective** - To ensure that differences between physical inventory and book value are investigated properly. - To ensure that only approved adjustments are processed. **Suggested Controls** - Differences between inventory counts and book records are investigated thoroughly before adjustments are approved and processed. - A policy on the follow-up of inventory differences has to be in place.

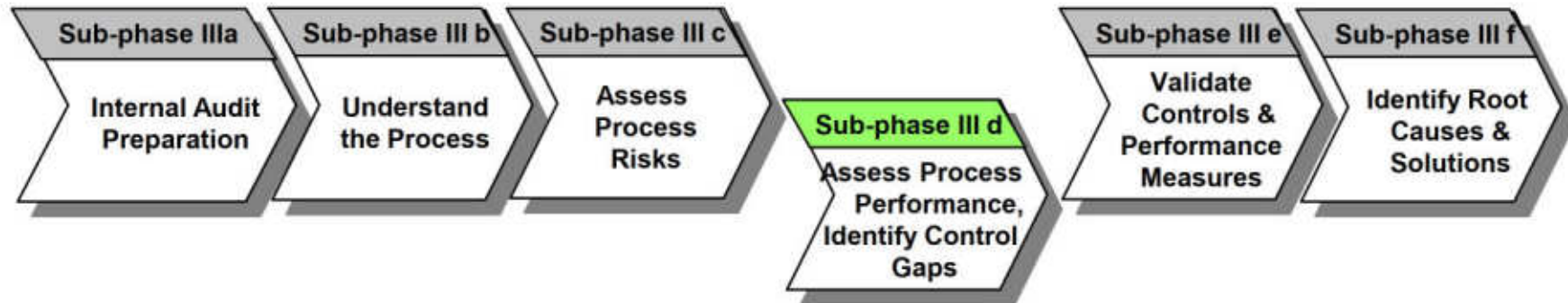| 9	Inventory performance measurement			
9.1	Performance measurement	**Audit Step:** - Obtain an overview of performance measurements and assess its adequacy. - Assess how performance variances followed up.	**Risks:** Shortfalls are not identified and corrected.	**Controls:** **Control Objective** To ensure that inventory performance is measured and monitored. **Suggested Controls** A policy on performance measurement has to be in place. Performance against target is measured and reported by the unit and individual planner.

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III d – Assess Process Performance, Identify Control Gaps - Objectives

- The main objectives of the sub-phase Assess Process Performance, Identify Control Gaps are to:

  ‣ Identify the existing controls in the process which address the identified risks, determine where controls are missing

  ‣ Understand how the performance of process controls is monitored and measured

  ‣ Identify the most significant controls and gaps between actual and desired performance of process controls as priorities for further investigation and testing in subsequent phases

Assess Process Performance, Identify Control Gaps
Overview of Steps and Deliverables

Sub-phase IIIa	Sub-phase III b	Sub-phase III c	Sub-phase III d	Sub-phase III e	Sub-phase III f
Internal Audit Preparation	Understand the Process	Assess Process Risks	Assess Process Performance, Identify Control Gaps	Validate Controls & Performance Measures	Identify Root Causes & Solutions

Steps

- Identify controls including the relevant performance measures

- Evaluate design of controls and performance measures

- Identify control gaps

- Identify "quick wins"

Deliverables

- Documentation of identified controls for the selected risks

- Documentation of assessment of control design

- Documentation of analysis of process performance measures

- Documentation of control gaps and recommendations for adequate control design for required controls

Execution and documentation of Work Program steps

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Assess Process Performance,
Identify Control Gaps – Risk / Control Balance

- The assessment of the design and operating effectiveness of a control is always also an assessment of the cost of the control
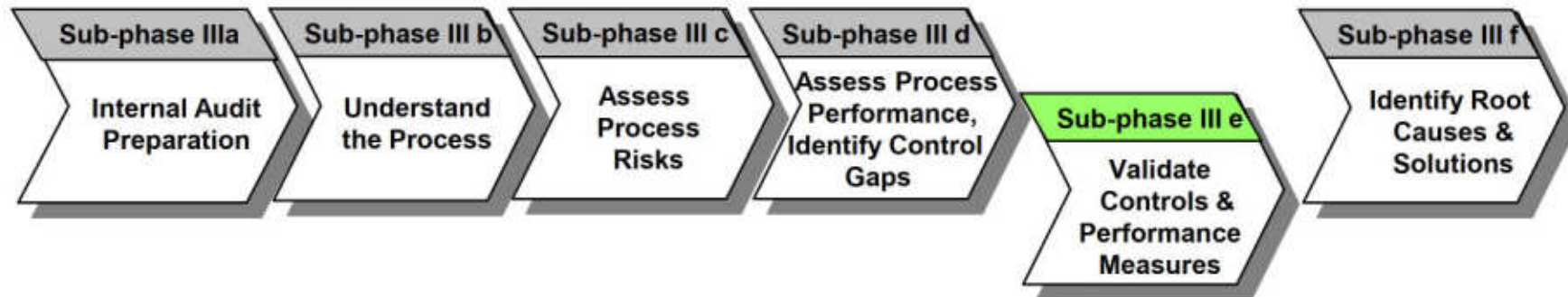
III e – Validate Controls and Performance Measures - Objectives

- The main objectives of the Sub-phase IIIe – Validate Controls and Performance Measures are to:

  - Determine, based on tests of the key controls, whether process controls are operating effectively and efficiently to manage or mitigate identified process risks

  - Determine that key performance measures, and other decision-making information which Management relies on, are relevant and reliable

Validate Controls and Performance Measures
Overview of Steps and Deliverables

Sub-phase IIIa	Sub-phase III b	Sub-phase III c	Sub-phase III d	Sub-phase III e	Sub-phase III f
Internal Audit Preparation	Understand the Process	Assess Process Risks	Assess Process Performance, Identify Control Gaps	Validate Controls & Performance Measures	Identify Root Causes & Solutions

Steps

- Determine type and extent of tests

- Design and perform tests

- Document and analyze results

Deliverables

- Documented audit test results and conclusions

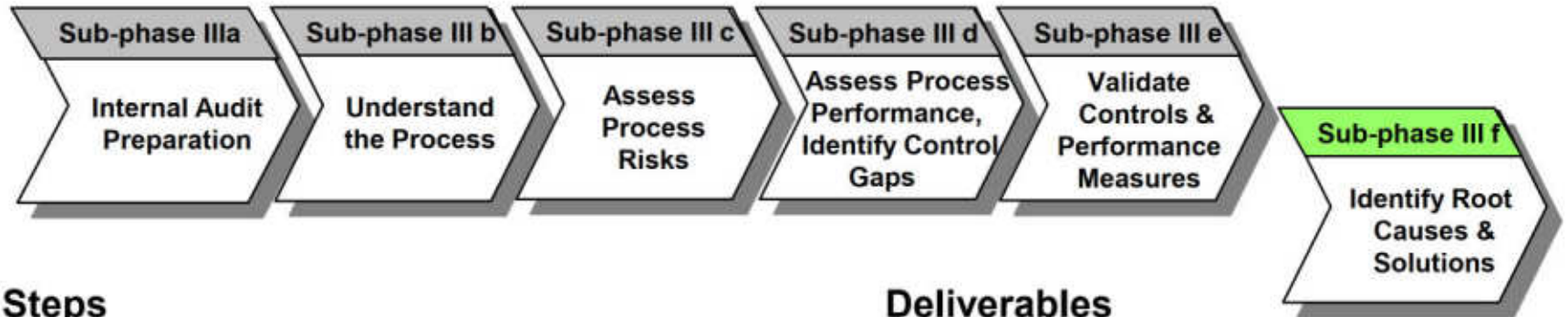**Execution and documentation of Work Program steps**

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III f – Identify Root Causes and Solutions Objectives

- The main objectives of the Sub-phase IIIf – Identify Root Causes and Solutions are:

  - Capture and further analyse the process control and performance gaps identified in the previous phases

  - Determine the root causes of the control and performance gaps

  - Develop practicable solutions that can be implemented to address these gaps. If appropriate, develop high level implementation plans for the solutions

  - Validate the identified control gaps and the proposed solutions with process owners and Management

  - Document the observations and recommendations as Exceptions in WP, rate exceptions

  - Complete the field work and prepare for the Internal Audit Reporting phase

Identify Root Causes and Solutions
Overview of Steps and Deliverables

Sub-phase IIIa	Sub-phase III b	Sub-phase III c	Sub-phase III d	Sub-phase III e	Sub-phase III f
Internal Audit Preparation	Understand the Process	Assess Process Risks	Assess Process Performance, Identify Control Gaps	Validate Controls & Performance Measures	Identify Root Causes & Solutions

Steps

- Define gaps/observations to be further analyzed

- Identify causes of gaps

- Rate significance of gaps/observations

- Define possible corrective action to control and performance gaps

- Formulate observations, risks, recommendations for action plans

- Obtain Process Owner / Management response

- Complete field work, prepare for reporting

Deliverables

- Validated and documented observations

- Narrative of related risks

- Documented solutions / recommendations

- Completed documentation of performed audit procedures

Execution and documentation of Work Program Steps

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Identify Root Causes and Solutions – Main Steps (I)

- Define gaps/observations to be further analyzed

  ‣ Note: assess the effectiveness of controls also independently of the persons who perform them. Will the control be effective if other (less conscientious) employees were hired? Is it pure luck that nothing has gone wrong so far? Is the control itself effective?

- Identify root causes of gaps

  ‣ Trace the reason for a control deficiency back to a reasonable, actionable root cause (why is the control not effective?) The answer is not always what first springs to mind.

- Rate significance of control gaps/observations

  ‣ This step requires business perspective and judgment. The relevance of the risk / observation is to be assessed in respect of the process reviewed, the organisation the process is embedded in, and the group as a whole.

High
A control weakness or issue that requires urgent attention as it exposes the Group Company to a significant and/or unacceptable level of risks.

Medium
A control weakness or issue that requires prompt attention as it entails significant operational problems, inefficiencies or process malfunctions.

Low
A control weakness or issue that does not necessarily warrant prompt attention but nevertheless will assure greater efficiency and/or effectiveness.

Identify Root Causes and Solutions – Main Steps (II)

Criteria Condition Cause Effect (Risk)

- **Formulate observations, risks, recommendations for action plans in writing in WP**

  ➤ Take due care when formulating observations and risks – the readers do not have all the background information you have. Base your observations on (quantitative) facts. The description of the observation and the related risk is the "selling argument" for your recommendation.

  ➤ Define suggested corrective action to control and performance gaps; Practicable, value adding, economically sensible (cost / benefit). Would you implement this corrective action?

  ➤ Do NOT use the formulation "Management should analyse" – it is the job of IA to perform the analysis and find out the facts.

  ➤ Write with the reader in mind.

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Identify Root Causes and Solutions – Main Steps (III)

- **Validate** the **written** observations and recommendations with Process Owner / Management

  - Do they understand what you mean, do they agree?
  - Is your analysis correct, valid relevant and conclusive?
  - This is the last moment to correct any mistakes and misunderstanding before the draft report is issued
  - If necessary, go back and review your work, perform further interviews and analyses. The facts in your report have to be valid and correct.

- **Complete field work**, prepare for reporting

  - Wrap up any open issues
  - Verify that you have covered the scope and objectives you intended (you do this continuously during field work)
  - Verify that you have completed your work program
  - Organize your work papers (WP)
  - Complete documentation in WP

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Identify Root Causes and Solutions – Rating of Observations

High

A control weakness or issue that requires <u>urgent</u> attention as it exposes the Group Company to a significant and/or unacceptable level of risks.

Medium

A control weakness or issue that requires <u>prompt</u> attention as it entails significant operational problems, inefficiencies or process malfunctions.

Low

A control weakness or issue that does not necessarily warrant prompt attention but nevertheless will assure greater efficiency and/or effectiveness.

Minor issues, which can instantaneously be rectified by the process owner upon notification are so-called **"Housekeeping"** issues. These are documented in WP but are not included in the IA report, nor are they rated.

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