Moss Adams
Busting the Myths Surrounding Internal Audit

Presenters:
Matt Doxtator, CPA, CIA, CFE – Assurance Senior Manager
Aaron Hamilton, CPA – Assurance Senior Manager

Agenda

- Getting to Know You
- Presenter Backgrounds
- Topic Background
- Popular Internal Audit "Myths" vs Reality
- Tips for Making Internal Audit More Affective
- General Tips for Participation in Assurance Services

Objectives

- Be able to define internal audit
- Differentiate between accounting and auditing and between external and internal auditing
- Be able to “bust” some common myths surrounding internal audit
- Understand the basics of internal control including responsibilities for and limitations of internal control
- Learn ways to enhance the effectiveness of internal audit activities
- Have a little fun

Getting to Know You

Quick Poll

- Auditors in the Past?
- Current Auditors?
- Accountants?
- IT Professionals?
- Other Administrators?

Why Talk About Internal Audit?

- Focus area for state and local governments
- The changing profession of public accounting
  - Compliance activities moving toward automation
  - CPA firms taking a more consultative role
- Changes to internal auditing standards and techniques
  - 2017 update to IIA's international professional practices framework
  - Continued adoption of data analytics
- Changing needs and expectations of information users
  - Shift from historical to forward-looking
  - Focus on continuous monitoring

Common Myths Surrounding Internal Audit

1. Internal Auditors Do the Same Thing as the External Auditors.
2. Financial Statement Auditors Are Specifically Engaged to Detect Fraud.
3. Internal Auditors are Accountants by Training.
4. Internal Audit is the Corporate Police.
5. Internal and External Auditors Don't Communicate or Work Together.
6. Internal Auditors Just Follow a Cycle and Checklists – They Audit the Same Things the Same Way Each Year.
7. Risk Assessment and Internal Control are the Internal Auditors' Responsibilities.

Myth 1: Internal Auditors Do the Same Thing as the External Auditors

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External Financial Statement Audit

- Provide users of financial statements with "reasonable assurance" that the financial statements are free of "material misstatements" and are prepared in accordance with Generally Accepted Accounting Principles ("GAAP").
- Management is responsible for the fair presentation of the financial statements.
- Auditor is responsible for expressing an opinion on the financial statements based on their audit.
- Auditing standards established by AICPA (GAAS) and GAO (GAGAS/Yellowbook)
- GAAP established by the FASB or GASB

Myth 1: Internal Auditors Do the Same Thing as the External Auditors

Internal Auditing

- An independent, objective audit and consulting activity.
- Designed to add value and improve an organization's operations.
- Helps an organization accomplish its objectives.
- Brings a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.
- Standards established by Institute of Internal Auditors (IIA).
  - Do not supersede AICPA standards.
  - Required to be followed by Certified Internal Auditors (CIA's).
- Each entity makes their own rules.

Myth 1: Internal Auditors Do the Same Thing as the External Auditors

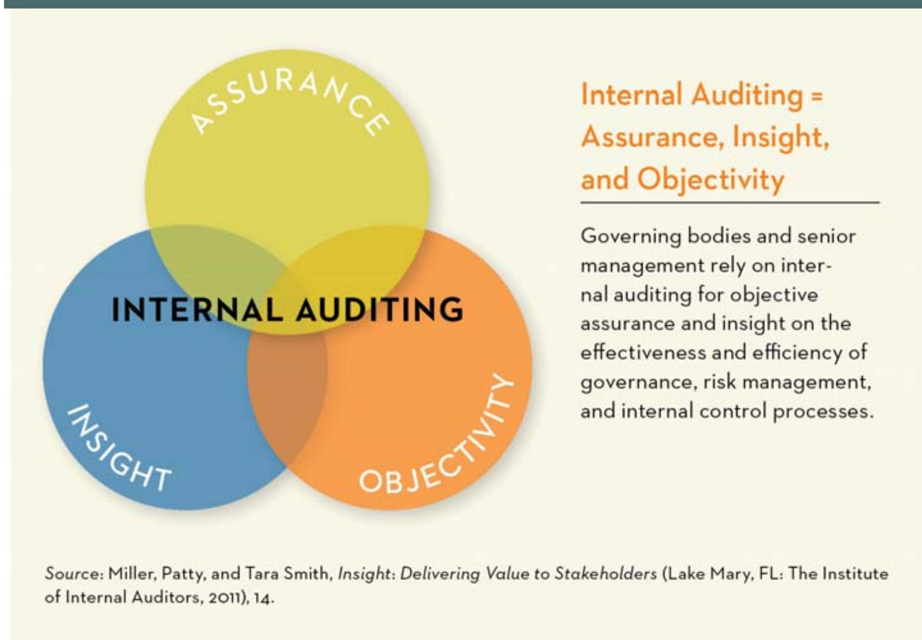
Key Terms	
Risk Management	Conducted by management to understand and deal with uncertainties (risks and opportunities) that could affect the organization's ability to achieve its objectives.
Governance	Conducted by the board of directors to authorize, direct, and oversee management toward the achievement of the organization's objectives.
Control	Conducted by management to mitigate risks to acceptable levels

Myth 1: Internal Auditors Do the Same Thing as the External Auditors

Internal Auditing Value Proposition

- Assurance = Governance, Risk & Control
- Insight = Catalyst, Analyses & Assessments
- Objectivity = Integrity, Accountability & Independence

Internal Audit Value Proposition



Myth 1: Internal Auditors Do the Same Thing as the External Auditors

How are external and internal audits similar?

- Both require independent personnel
- Both approach their work with professional skepticism
- Both evaluate and test the internal control structure
- Both typically take a risk-based approach
- Both work with audit programs and test samples of transactions
- Both report to those charged with governance

Myth 1: Internal Auditors Do the Same Thing as the External Auditors

How do external and internal audits differ?

- **INTERNAL** does not require compliance with external audit standards, nor does it typically contemplate GAAP.
- **INTERNAL** is not subject to materiality thresholds.
- **EXTERNAL's** primary focus is on the GAAP financial statements, while **INTERNAL** can be broader in scope.
- **INTERNAL**, in general, can be more flexible than an **EXTERNAL** financial statement audit.

Myth 1: Internal Auditors Do the Same Thing as the External Auditors

Internal Audit	External Audit
Organization's employee or outsourced	Independent contractor
Serves the needs of the organization	Serves external parties who need reliable financial information such as investors
Focuses on future events by focusing on evaluating controls to help the organization accomplish its goals and objectives	Focuses on accuracy and understandability of historical events e.g. in financial statements
Directly concerned with prevention of fraud	Directly concerned with fraud when financial statements may be materially affected
Independent of activities audited but responsive to needs of management	Independent of management and the Board
Reviews activities continually	Reviews records supporting financial statements periodically – usually yearly

Knowledge Check

Fill in the blanks:

Internal auditing is an independent, objective _assurance_ and _consulting_ activity designed to add value and improve an _organization_'s _operations_. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of _risk_ management, _control_ and governance processes.

Myth 2: Financial Statement Auditors Are Specifically Engaged to Detect Fraud

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Sort these methods of detecting fraud from most common to least common.

- External audit
- Management review
- Internal Audit
- Tip
- Accident
- Account reconciliation

Myth 2: Financial Statement Auditors Are Specifically Engaged to Detect Fraud

According to the 2018 ACFE Report to the Nations, occupational frauds reported are most commonly detected by:

1. Tip – 40%
2. Internal Audit – 15%
3. Management Review – 13%
4. Accident – 7%
5. Account Reconciliation – 5%
6. External audit – 4%

From 2014 to 2018 Internal audit went from 3rd to 2nd most common method of detection

Myth 2: Financial Statement Auditors Are Specifically Engaged to Detect Fraud

GAO	Assess the risk of fraud occurring that is significant within the context of the audit objectives
	Report relevant information about fraud when material, either quantitatively or qualitatively, to the financial statements or audit objectives
	Communicate in writing to entity officials identified or suspected fraud that is less than material
AICPA	Obtain <u>reasonable assurance</u> financial statements as a whole are free from material misstatement, whether caused by <u>fraud</u> or <u>error</u>
	Must communicate knowledge of fraud to appropriate level of management on a timely basis
	Communicate fraud to those charged with governance when involving: 1) management, 2) those with significant roles in internal control and 3) others resulting in a material

Myth 2: Financial Statement Auditors Are Specifically Engaged to Detect Fraud

Unlike Financial Statement Auditors Internal Auditors are directly concerned with the prevention and detection of fraud

- Standard 1210 - Proficiency
- Standard 1220 – Due Professional Care
- Standard 2060 – Reporting to Senior Management and the Board
- Standard 2110 - Governance
- Standard 2120 – Risk Management
- Standard 2210 – Engagement Objectives

Knowledge Check

True or False – The primary responsibility for prevention and detection of fraud rests with the financial statement auditors.

False – Management and those charged with governance.

True or False – Anonymous tip hotlines are not an effective means for detecting fraud and complaints should not be investigated because most are just people with nothing better to do than complain.

False – tips are the #1 method for detecting fraud accounting for 40% of all fraud detection.

Myth 3: Internal Auditors are Accountants by Training

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First, it's important to distinguish between accounting and auditing:

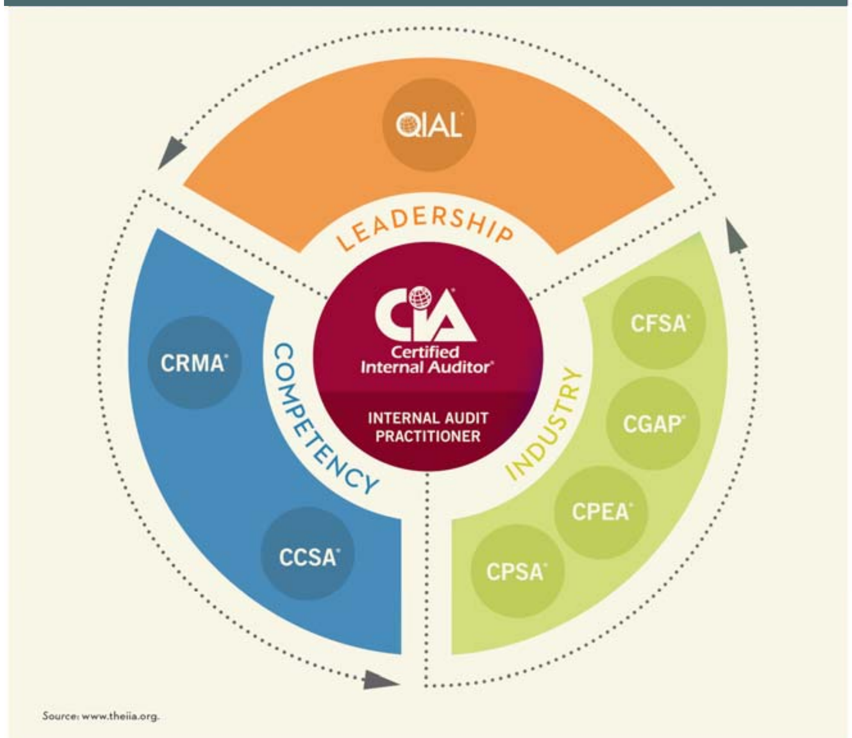
Accounting	Auditing
• collection, • classification, • summarization • and communication of financial data • measurement and communication of business events and conditions	• review the measurements and communications of accounting for propriety • analytical, not constructive • critical, investigative • emphasizes proof or support for financial statements and data • rooted not in accounting but in logic

Myth 3: Internal Auditors are Accountants by Training

- Goal of IA is to help an organization accomplish its objectives
    1. Strategic
    2. Operational
    3. Reporting
    4. Compliance
- Accountants responsible for #3
- External auditors primarily concerned with #3
- Internal auditors are concerned with all four and training should reflect that.
- **IPPF Standard 1210 – Proficiency**
    - Internal audit activity collectively must possess or obtain the knowledge, skills and other competencies needed to perform its responsibilities
    - Includes knowledge to evaluate risk of fraud and management of those risks
    - Includes knowledge of key information technology risks and controls

Myth 3: Internal Auditors are Accountants by Training

IIA Global Certifications and Qualifications



Myth 4: Internal Audit is the Corporate Police

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- Definition of internal audit includes both assurance and consulting functions
- **IPPF Standard 2100 – Nature of Work**:
  - The internal audit activity must evaluate and contribute to the improvement of the organization's governance, risk management and control processes.
  - Credibility and value are enhanced when auditors are proactive and their evaluations offer new insights and consider future impact.
- The best internal auditors are those who create a rapport with their clients.

Knowledge Check

The internal audit function should have suitable skill and knowledge to perform its responsibilities which include helping an organization achieve which types of objectives?

A. Strategic

B. Operational

C. Reporting

D. Compliance

E. All of the above

Myth 5: Internal and External Auditors Don't Communicate or Work Together

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- **IPPF Standard 2050 – Coordination and Reliance:** Internal Audit should share info and coordinate activities with external assurance providers
  - ensure proper coverage
  - minimize duplication of effort

- Both GAGAS and GAAS allow financial statement auditors to rely on the work of internal auditors to gather evidence or in assessing the design or operation of internal control
  - Have to consider the competency of the internal audit function
  - Does organizational status support? Objectivity?
  - Is systematic and disciplined approach, including quality control applied?

Myth 5: Internal and External Auditors Don't Communicate or work together

How can internal audit directly assist external audit?

- Assist in identifying risk areas
- Testing of 'key' internal controls
  - Disbursements
  - Payroll
  - Daily revenue paperwork
- Observations of internal control procedures
- Test counts and observations of inventories and other physical assets

Myth 6: Internal Auditors Just Follow a Cycle and Checklists – They Audit the Same Things the Same Way Each Year

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IPPF Standard 2010 - Planning

- Professional standards require risk-based plans to determine priorities
- Risk assessment at least annually; should include input of senior management and the board
- Internal Audit Plan align with the organization’s goals (strategic, reporting, compliance, operational)
- Internal Audit Leadership (whether employees or outsourced professionals) must identify and consider the expectations of senior management, the board and other stakeholders.

IPPF Standard 2020 – Communication and Approval

Internal Audit Leadership must communicate plans and resource requirements to senior management and the board for review and approval.

Myth 7: Risk Assessment and Internal Control are the Internal Auditors' Responsibilities

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- Risk Assessment – analysis of the impact of uncertainties
- Internal control – activities that help ensure objectives are achieved
- Everyone in an organization has responsibility for internal control:
  - Board of Directors
  - Management
  - Other Personnel
  - Internal Auditors

Myth 7: Risk Assessment and Internal Control are the Internal Auditors' Responsibilities

"Supporting the organization in its efforts to achieve objectives are five components of internal control" - COSO

- Control Environment
- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring Activities

Internal Control Reminders

- Accountability for internal control must be enforced
- Focus should be on the substance of internal control rather than the form
- Design of internal controls must be reevaluated to address significant changes in processes
- Limitations of internal control
  - Reasonable assurance
  - Cost benefit
  - Collusion
  - Override
  - Human error in judgement
  - Breakdown in performance
- Trust is not a control
- Ignorance is not a control

Things You Can Do to Enhance the Internal Audit Process

Things You Can Do to Enhance the Internal Audit Process

Know Your Responsibilities	
Management	• Timely and accurate financial reporting • Design and operation of internal controls • Identification, assessment and communication of risks • Compliance with laws and regulation • Prevention and detection of fraud
External Auditor	• Coordinate with and rely on the work of internal auditors when possible • Clearly communicate the scope of the audit and clarify incorrect perceptions or unrealistic expectations • Help auditees understand audit objectives to facilitate production of evidence • Take the time to thoughtfully communicate internal control deficiencies

Things You Can Do to Enhance the Internal Audit Process: Management Do's and Don'ts

Do:

- Actively participate - provide input to help the internal audit function design risk-based on audit plan
- Communicate - speak up when you identify duplication of effort between external and internal auditors
- Seek to understand – facilitate the process by understanding the audit objective.
  - Helps ensure audit requests are appropriate
  - Minimize wasted effort, frustration of your personnel
- Make sure you and your personnel are familiar with fraud red flags and communicate them
- Consider ways to leverage the skills and knowledge of internal auditors through additional consulting engagements
  - Effectiveness or efficiency of operations
  - Compliance
  - Reporting

Things You Can Do to Enhance the Internal Audit Process: Management Do's and Don'ts

Don't:

- Assume the internal auditors are out to get you. It is a myth that auditors are nit-pickers and fault finders
  - Objectivity
  - Potential Biases
- Assume internal control and risk assessment is someone else's responsibility
  - Board
  - Senior management
  - Other employees
- Instruct your personnel to automatically push back on all audit requests
- Instruct your personnel to not to tell internal auditors anything unless they specifically ask

A Little Fun

Participation Question

What are some common misguided or ironic comments, questions or sources of frustration that you've experienced as an auditor or auditee?

As Auditees:

- I only have a couple more requests/questions.
- We're here to help.
- Assumption that the world stops during the audit
- 11^{th} hour requests for additional information
- Impractical internal control suggestions

Participation Question

What are some common misguided or ironic comments, questions or sources of frustration that you've experienced as an auditor or auditee?

As Auditors:

- We're not following that policy anymore
- That's not material
- The old auditors never asked for that
- Okay we provided the last requested item, can we have the financial statements tomorrow?

Contact Information

Matt Doxtator, CPA, CIA, CFE
Assurance Senior Manager | Moss Adams
_____
6565 Americas Parkway NE
Suite 600
Albuquerque, NM 87110

D (505) 878-7277
T (505) 878-7200
M (505) 379-2867

Aaron Hamilton, CPA
Assurance Senior Manager | Moss Adams
_____
6565 Americas Parkway
Suite 600
Albuquerque, NM 87110

D (505) 837-7630
T (505) 878-7200
M (970) 946-0311

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