CHAPTER 13
CONDUCTING THE ASSURANCE ENGAGEMENT
Illustrative Solutions

Review Questions

1. The four reasons why an assurance engagement might be conducted are as follows:

   a. The engagement was identified in the annual internal audit plan because of inherent risks identified during the business risk assessment process, risks detected the last time the area was audited, and other relevant factors. For these engagements, the internal auditor must understand what underlying business risks caused the engagement to be included in the plan, and then design the engagement plan to provide the appropriate assurance regarding the design adequacy and operating effectiveness of controls implemented to mitigate those risks.

   b. The engagement is part of an annual requirement to evaluate the organization's system of internal controls for external reporting purposes, such as the U.S. Sarbanes-Oxley Act of 2002 Section 404 requirements in the United States and similar financial reporting laws in other countries. For these engagements, the internal auditor must ensure that the engagement is designed to test the areas covered by the underlying regulations (for example, provide assurance regarding the design adequacy and operating effectiveness of internal control over financial reporting).

   c. A recent event (for example, natural disaster, fraud, or customer bankruptcy) has tested the process under unusual circumstances and management desires a "post mortem" to determine where the process was effective and where it was not. For these engagements, the internal auditor must tailor the testing and evaluation around the specific event that occurred.

   d. Changes in the business or industry require immediate modifications to the process and management desires a quick validation that these modifications appear to be designed appropriately to address the changes. For these engagements, the internal auditor may perform a full controls-focused audit or they may scope it to focus only on the controls that changed.

2. The following are typical scope statements:

   a. Boundaries of the process.
   b. In-scope versus out-of-scope locations.
   c. Subprocesses.
   d. Components.
   e. Time frame limitations.

3. The five types of exceptions are:

   a. Financial statement errors or misclassifications.
   b. Control deficiencies.
   c. Shortfalls in objective achievement.
   d. Inefficiencies.
   e. Out-of-compliance situations.

4. Operational objectives are the most common process objectives. This is due to the fact that most auditable processes are created to support an important but non-strategic aspect of the business. Such objectives tend to be task oriented, which lend themselves to auditing. Reporting and compliance objectives are frequently embedded in or produced as a by-product of operational processes. Strategic processes tend to be less task-oriented and more subject to the judgments and efforts of individuals.

5. The following are potential sources of useful process information from process owners:

   a. Policies relating to the process.
   b. Procedures manuals.
   c. Organizational charts or similar information outlining the number of employees and key reporting relationships.
   d. Job descriptions for people involved in the process.
   e. Process maps or flowcharts depicting the overall flow of the process.
   f. Narrative descriptions of key tasks or portions of the process.
   g. Copies of key contracts with customers, vendors, outsourcing partners, etc.
   h. Relevant information regarding laws and regulations affecting the process.
   i. Other documentation that may have been developed to support required reporting on the effectiveness of the system of internal controls.

6. Understanding the tasks in a process is an important step in planning an engagement. However, these tasks describe the way a process is designed to perform, but provide little indication regarding how effectively they are carried out. Performing analytical procedures is one way internal auditors conduct high-level assessments that may reveal process activities that warrant closer attention and, accordingly, more detailed testing.

7. Entity-level controls are, by definition, pervasive and, therefore, may influence controls across the organization. Weaknesses in entity-level controls can make it easier to circumvent controls within a process that are otherwise well designed. The existence of entity-level control weaknesses may cause the internal auditor to apply more direct and substantive tests of controls with potentially larger sample sizes to satisfy audit objectives and provide reasonable assurance that the entity-level weaknesses did not cause the process-level controls to operate ineffectively.

8. The three common ways are high-level flowcharts, detailed flowcharts, and narrative memoranda.

9. There are two key reasons internal auditors must identify and understand process-level key performance indicators (KPIs). First, it tells the auditor how process-level control activities are monitored, which aids in the evaluation of both the design adequacy and operating effectiveness of the process. Second, KPIs give an indication of management's tolerance levels surrounding the process. This provides the internal auditor with insights as to how to evaluate the significance of testing exceptions or observations.

10. When an individual intends to commit a fraud or there is collusion among multiple individuals, the inherent likelihood of a given risk may be greater. The likelihood of a risk is commonly assessed assuming individuals are honest and intend to do the right thing.

11. A process-level risk scenario is any realistic event or situation that could make it difficult to achieve one or more process-level objectives. Each scenario can be thought of as a separate root cause impacting those objectives. Process-level risks represent a collection of like scenarios or root causes that have similar characteristics. The reason for grouping risk scenarios in this manner is that typically the similar root causes can be managed in a comparable manner. This classification of scenarios helps simplify risk assessment and risk management.

12. The following are the three primary steps that should be followed when gaining an understanding of management's risk tolerance levels:

a. **Identify Possible Risk Outcomes.** By definition, risks represent a range of possible outcomes. While such outcomes typically are measured in financial terms, there may be other risk outcomes that either do not lend themselves to financial measurement or are more severe than the financial impact. For example, the safety of employees may be more severe than potential fines or penalties due to safety violations. Similarly, the impact of failure to protect the privacy of customer data may be more severe than the cost to recover or protect such data.
b. **Understand Established Tolerance Levels.** Once the different risk outcomes are determined, discussions can be held with process management to identify tolerance levels that they have already established. Such levels may be reflected in documentation of key performance measures, individual performance goals, or in other communications.
c. **Assess Tolerance Levels for Outcomes that Have Not Been Established.** To the extent that established tolerance levels do not comprehensively address all possible risk outcomes, discussions should be held with process management to determine appropriate tolerance levels. Questions to facilitate this discussion include:
   - How much variability can you or senior management tolerate relative to the achievement of process objectives?
   - What types of outcomes would you consider to be unacceptable?
   - What types of risk scenarios would you be uncomfortable dealing with?

13. Common controls that typically operate before a transaction is completed include approving, examining, matching, and, potentially, supervising.

14. As indicated in the chapter, the following are the key questions to be considered when evaluating the adequacy of process design.

    a. Does the internal auditor understand what an "acceptable level" of risk is, based on management's risk tolerance levels for the process?
    b. Do the key control activities, taken individually or in the aggregate, reduce the corresponding process-level risks to acceptable levels?
    c. Are there additional compensating controls from other processes that further reduce risks to acceptably low levels?
    d. Does it appear that the key controls, if operating effectively, will support the achievement of process-level objectives?
    e. To the extent appropriate, does the process design address effectiveness and efficiency of operations, reliability of financial reporting, compliance with applicable laws and regulations, and achievement of strategic objectives?
    f. What gaps, if any, exist to improve the effectiveness and efficiency of the process?
       1) What specific gaps exist in the design of the process?
       2) What are the possible outcomes or effects of those gaps?
       3) Why do these gaps exist — that is, what are the root causes?

15. When designing a testing approach, an internal auditor must consider the nature, extent, and timing of tests to be performed.

16. Following are the tasks covered in the typical work program:

    a. Key administrative tasks, such as preparation of a planning memorandum, scheduling resources, establishing milestone dates, etc.
    b. Conducting a kick-off meeting with process-level management to discuss the objectives and scope of the engagement, process-level risks, timing of the engagement, information needed from

process-level employees, reports or other deliverables, and any expectations management has of the engagement.

c. Planning tasks, which list each of the tasks discussed in this chapter.
d. Fieldwork tasks, which list the specific tests that will be conducted.
e. Wrap-up steps, such as clearing open review notes, conducting a closing meeting with process-level management, finalizing the workpapers, etc.
f. Reporting tasks, such as preparing a draft engagement communication, soliciting feedback from process-level management, and issuing a final engagement communication (covered more fully in Chapter 14, *Communicating Assurance Engagement Outcomes and Performing Follow-up Procedures*).

17. The following should be considered when allocating resources and scheduling an engagement:

1. Availability of key process personnel.
2. Availability of engagement resources.
3. Availability of outside resources.
4. Availability of key reviewers.

18. The internal auditor must consider the following questions when evaluation evidence gathered from audit testing:

a. Are the key controls designed adequately?
b. Are the key controls operating effectively, that is, as they are designed to operate?
c. Are the underlying risks being mitigated to an acceptable level?
d. Overall, do the design and operation of the key controls support achievement of the objectives for the process or area under review?

Multiple-choice Questions

1. **B** is the best answer. The internal auditor does not guarantee anything. Internal audits provide only reasonable assurance. Each of the other three responses could be a way to phrase an assurance engagement objective.

2. **D** is the best answer. The approval is required by policy and, as such, the objective is a compliance objective. It is important to note that if students follow the COSO definitions, they may answer B since COSO more narrowly defines compliance as relating to laws and regulations. However, the authors prefer the broader definition of compliance objectives, as provided by The Institute of Internal Auditors (IIA), which includes compliance with outside laws and regulations as well as compliance with internal policies and contracts.

3. **D** is the best answer. Analytical procedures can be used during planning to reveal process activities that may warrant closer attention and, accordingly, more detailed testing. Analytical procedures also can be used when performing an engagement to identify anomalies that may indicate (1) a control is not operating effectively or (2) a potential fraud or irregularity.

4. **C** is the best answer. While policies and procedures manuals, organization charts and job descriptions, and memoranda listing key tasks will all be helpful, only detailed flowcharts provide the internal auditor with a start to finish view of how the process operates, including key risks and controls.

5. **B** is the best answer. The other three are examples of entity-level controls, while B is an example of a process-level control.
6. **A** is the best answer. It is important for the internal auditor to understand the overall process objectives, but these are not typically documented in flowcharts or narrative memoranda.
7. **D** is the best answer. The other three choices likely would have some impact on financial reporting, but the pursuit of a new sales channel likely will not have a financial reporting impact.
8. **D** is the best answer. The first two choices (senior management and process-level management) should be obvious from the chapter. It is important to remember that the internal audit function's risk tolerance level is also important. While the tolerance levels of the others must be understood, the internal audit function still has a fiduciary responsibility to all stakeholders and, thus, should not subordinate its own tolerance levels to those of others. The tolerance levels of vendors and customers, while of some interest, do not really have much bearing on the focus of an assurance engagement.
9. **B** is the best answer. While there may be treasury reasons to direct the deposit to certain accounts, overall this control will likely have little impact on safeguarding of assets or financial reporting objectives. Each of the others could be key controls.
10. **B** is the best answer. Despite the design inadequacy, there is still a possibility that compensating controls in other (adjacent) processes (either upstream or downstream) will mitigate the design inadequacy, resulting in no need to change the process design. Note that some students may argue that such controls should be considered as part of the process. However, the scope of many engagements will not necessarily consider all upstream and downstream controls. The other three options may not be effective or efficient in determining whether the process-level objectives have been achieved.
11. **D** is the best answer. Some testing exceptions may indicate that a potential exception condition was not adequately contemplated when preparing the test plan and additional testing is required to determine whether a control deficiency exists. In other instances, it is clear that a control deficiency exists, but until the root cause is understood, the nature of a relevant recommendation may not be clear. Finally, some testing exceptions are clear indications of a control deficiency and no additional analysis is necessary, so the internal auditor can begin drafting the observation for the report.
12. **C** is the best answer. Without evaluating the results of testing for the whole process, the internal auditor cannot come to any conclusions regarding the achievement of objectives, the existence of fraud, or the overall effectiveness of internal control activities. An observation is an indication that one or more risks have not been mitigated, although the internal auditor may need to evaluate compensating control activities before finalizing his or her conclusion.
13. **A** is the best answer. While each of the other answers may be outcomes from an observation, before adequate follow-up and vetting with management is completed, the only requirement is that the internal auditor document the observation in the working papers.

Discussion Questions

1. While the underlying objectives of an assurance engagement may be similar, the outcomes and deliverables can vary widely, depending on those objectives and the audience receiving the deliverables. Specifically:

a. By being able to anticipate the outcomes of an engagement, the internal auditor can plan the appropriate tests to provide reasonable assurance that potential discrepancies will be detected. This may also reduce the amount of additional testing that would need to be performed to evaluate the extent and magnitude of detected discrepancies because the auditor's expectations can be built into the original engagement testing plan.

b. By understanding the nature, extent, and format of the deliverables, the internal auditor can focus on ensuring that all necessary information is gathered and documented to support the key areas of the deliverables.

2. As indicated in the chapter, the internal auditor needs to approach the process as a component of the organization as a whole and, thus, certain process-level objectives can be considered strategic in nature. It is important for the internal audit function to understand which of the process objectives align directly with the organization's strategic objectives. This will make it easier to associate the process objectives with entity-wide risks. Also, by viewing certain process objectives as strategic, the internal auditor will gain an appreciation for the internal customers' expectations of the process and, as a result, consider those expectations when designing the audit approach.

3. Management is responsible for optimizing the return on assets. This requires a consistent focus on reducing residual risk and taking advantage of opportunities. To do this, management ensures they have developed good strategic direction and policies, hired and developed the right people to carry out that direction, and enabled those people with tools and information to carry out that direction effectively and efficiently. They empower people, and then assume those people will do their jobs, subject to oversight and monitoring. Therefore, their focus is on managing risks to an acceptable level.

   Internal auditors, on the other hand, cannot assume people will do their jobs consistently, policies make sense, and enabling tools and information will achieve the desired result. While consideration of residual risk is still relevant, internal auditors also must consider the possibility that the above assumptions are not correct and, as a result, conduct engagements to provide assurance about the design adequacy and operating effectiveness of control activities.

4. Failure to identify all of the key risks inherent within a process being reviewed may result in the internal auditor:

   a. Inappropriately concluding that the process design is adequate.
   b. Not testing enough key controls to evaluate whether the controls are operating effectively.
   c. Failing to identify actual or potential indications of fraud.
   d. Neglecting to test and consider the impact of compensating controls that reside in other processes.

   Determining that certain risks are key when they are not may result in unnecessarily testing controls, causing suboptimal deployment of valuable internal audit resources.

5. Following are examples of some, but not all, of the other possible risk outcomes:

   a. Reputational damage (for example, negative publicity in national newspapers).
   b. Harm to a person's health and safety (for example, employees, vendors, customers, or other visitors are injured while on company property).
   c. Environmental contamination (for example, a local water supply is polluted because of a spill from the company's plant).

d. Lost assets (for example, assets are stolen by employees or outsiders; the financial impact of the event can be easily recorded, but the loss may not be recovered).
e. Convictions (for example, failure to perform their fiduciary duties results in officers of the company being convicted and sentenced to jail terms).
f. Customer dissatisfaction (for example, selling flawed products may cause customers to look to other suppliers of the goods).
g. Employee dissatisfaction (for example, a poor relationship with management causes a high percentage of employees to seek employment elsewhere).
h. Liquidity impairment (for example, failing to comply with debt covenants results in all debt becoming currently payable).

6. Following are possible answers:

a. Potential business risks associated with each scenario are:
   i. Title to the materials may have passed to the company, and thus these represent unrecorded inventory and liability to pay. Also, failure to inspect the materials may result in acceptance of defective materials or materials that were not ordered.
   ii. The spare parts may be damaged or otherwise unusable. Additionally, there may be an excessive amount of certain parts that will realistically never be used. In both instances, inventory balances may be overstated or overvalued.
   iii. The barrels could leak or there may be other events associated with the escape of the hazardous chemicals that could create environmental incidents resulting in fines, penalties, health issues, and social issues should the chemicals leak into local water supplies.
b. Understanding the risks above will help the internal auditors design their procedures to focus on activities related to:
   i. The receipt of materials, particularly right before a period end or inventory count.
   ii. Procedures to assess whether parts and supplies are excessive, obsolete, or damaged.
   iii. Procedures to manage environmental and safety risks associated with the hazardous chemicals.

7. Following are possible answers:

a. In terms of assurance engagement appropriateness:

   i. Security of assets, including information, is very appropriate for an assurance engagement. The audit committee is looking for assurance related to the safeguarding of such assets, which is an integral part of an effective system of internal controls as covered in COSO's *Internal Control – Integrated Framework*.
   ii. Compliance with applicable laws and company policies is also an appropriate engagement. Compliance objectives are covered in COSO's ERM Framework.
   iii. Reliability of financial records is also an appropriate engagement. Reporting objectives are covered in COSO's ERM Framework.
   iv. Effectiveness of performing assigned responsibilities may or may not be appropriate, depending on the audit committee's specific expectations. It is appropriate to evaluate whether designed responsibilities are being performed effectively. However, if the audit committee was looking for input on whether the responsibilities are appropriate, this may require the internal audit function to conduct a consulting engagement (discussed in Chapter 15, "The Consulting Engagement."

v. Valuation of the spare parts inventory may or may not be appropriate, depending on the audit committee's specific expectations. It is management's responsibility to determine the appropriate valuation of the spare parts inventory. However, the internal audit function can provide assurance that management has designed an adequate process for determining that valuation, and the procedures to ensure an accurate valuation have been effectively performed.

b. Students may list the three areas covered under part c, all of which are appropriate answers. In addition, students may mention monitoring spare parts availability, accuracy and timeliness of providing information to customers (for example, product information, operating and maintenance information), customers' overall perception of customer service, timeliness of providing information to other AVF departments for follow-up or resolution, and effectiveness of key computer system functionality.

c. The following are potential audit tasks to address these responsibilities. Note that some of the tasks may provide consulting benefits as well as assurance benefits:

i. Customer training courses — Understand how the content of such courses was developed and review it for reasonableness; determine whether qualified people are conducting the training; assess how effectively feedback from the conduct of courses is addressed; and survey a sample of customers who have taken the course to determine its relevance and effectiveness.

ii. Customer complaints and service calls — Review documentation supporting how complaints were dealt with; contact a sample of customers to determine whether they were satisfied with the service; analyze trending of complaints to determine whether the root causes are being addressed; and analyze the cost effectiveness of trying to address customer issues over the phone versus dispatching a service technician.

iii. Warranty claims — Test a sample of both processed and rejected warranty claims to determine whether the claims should have been covered by warranty and whether they were handled properly; analyze trends in warranty claims to identify potential issues in the production process; and evaluate the process that management follows to estimate a reserve for unprocessed warranty claims.

8. Invoice 248: This is a deviation. Each recorded shipment and sales invoice should be supported by a sales order. Verbal authorization is not a valid substitute for written authorization.

   Invoice 333: This is a deviation. If the control policy specifies that verification be documented, and evidence thereof is lacking, a deviation has occurred whether or not quantities and prices are correct.

   Invoice 377: This is a deviation. If the control policy specifies that verification be documented, and evidence thereof is lacking, a deviation has occurred whether or not quantities and prices are correct.

   Invoice 617: This is a deviation. Evidence of approval is not relevant if it is obvious from reperformance that the approval was not performed as prescribed (operating effectiveness versus design adequacy).

9. This is a question that many internal audit functions are currently struggling with. Inability to manage strategic risks is by far the largest cause of significant company failures. However, the nature of most strategic risks is that they are not easily managed by processes or systems, and instead are heavily dependent on either decisions management makes or external events over which an organization has little control. Therefore, most strategic risks do not lend themselves to traditional assurance engagements. However, internal auditors can add value by considering audits focused on:

a. The governance process, which includes the strategic oversight provided by the board of directors and the board's delegation of authority to manage strategic risks.
b. The enterprise risk assessment process to assess whether all key strategic risks have been identified, appropriately assessed, and assigned to members of management.
c. Management's processes for monitoring risk indicators related to external risks.
d. Effectiveness of communicating key risk indicators and pertinent risk information so that decisions can be made as appropriate.
e. Reports that support key management decisions.
f. Management information systems that provide management with timely information upon which strategic decisions can be made.
g. Validity of other information that management relies on to support key decisions.

Case

The answers to this case will vary depending on the assumptions made by the students. The following are examples of what could be included in students' answers. Note that it may be helpful to debrief on certain sections of this case with students at periodic intervals and then provide them with a preferred answer to ensure they all have the same starting point for the next section.

Payroll Department Objectives

- Process all payroll transactions accurately.
- Process all payroll transactions timely.
- Remit taxes and other withholdings timely and accurately to the appropriate agencies.
- Classify all payroll transactions accurately in the financial records.
- Protect the privacy of employee information maintained within the payroll system.
- Ensure all existing and no non-existing employees are paid each pay period.

Potential Risk Scenarios

- Policies and procedures are not developed, documented, and communicated to ensure employees processing payroll transactions know management's expectations and understand how to carry out those expectations.
- Employees do not have the experience or training to carry out their assigned responsibilities.
- Inputs or updates to the payroll system (for example, pay rates, withholdings, etc.) are inaccurate or unauthorized.
- Non-existent/fictitious employees are included in the payroll records.
- The hours actually worked by hourly employees are not captured or not input accurately into the payroll system.
- The hours actually worked by hourly employees are falsified.
- Taxes and other withholdings are not properly deducted from employees' earnings.
- Taxes and other withholdings are not remitted timely or accurately to appropriate agencies.
- The functionality within the payroll system that computes payments and withholdings is flawed or inaccurate.
- Processing errors occur and are not detected prior to disbursement.
- Unauthorized individuals are able to access and make modifications to critical information in the payroll system.

- Unauthorized changes are made to the payroll system which affects the integrity of system-based functionality.
- Payroll processing does not occur timely to ensure employees are paid when due.
- Payroll transactions are not recorded accurately or timely in the financial statements.
- Accrued payroll and related benefits (for example, vacation pay) are not calculated and recorded accurately or timely.

Potential Payroll Risks

- The risks defined will depend on the risk scenarios, examples of which are listed above. It is important that students document their rationale for their impact and likelihood judgments.

IMPACT	**High**	**7**	**8**	**9**
	Medium	**4**	**5**	**6**
	Low	**1**	**2**	**3**
		Low	**Medium**	**High**
		LIKELIHOOD		

Potential Process Flow

- This will vary from student to student. Make sure that their detailed process flow covers, at a minimum, all process-level risks and key control activities.

Potential Key Performance Indicators

- Paycheck accuracy.
- Paycheck timeliness.
- Number of pay errors caught during the review/edit check sub-process.
- Number of payment deadlines missed.

Risk and Control Matrix – Design Adequacy

- This portion of the risk and control matrix should be completed based on the risks identified above and appropriate key control activities that may exist in the payroll function. The design adequacy conclusion should follow from the risk and key control columns.

Process-level Risk	Key Control Activity	Design Adequacy
Risk A – Definition (associated process-level objectives)	• Control Activity A • Control Activity B • Control Activity C	The indicated key control activities are adequate to manage this risk to an acceptable level.
Risk B – Definition (associated process-level objectives)	• Control Activity A • Control Activity D	The indicated key control activities are **not** adequate to manage this risk to an acceptable level (describe design gap).

Process-level Risk	Key Control Activity	Design Adequacy
Risk C – Definition (associated process-level objectives)	• Control Activity C • Control Activity E • Control Activity F	The indicated key control activities are adequate to manage this risk to an acceptable level.

Risk and Control Matrix – Testing Approach

- The testing approach should be reasonable based on the nature of the key control activities and the conclusions regarding design adequacy as documented above.

Process-level Risk	Key Control Activity	Testing Approach
Risk A – Definition (associated process-level objectives)	• Control Activity A • Control Activity B • Control Activity C	• Test A • Test B • Test C
Risk B – Definition (associated process-level objectives)	• Control Activity A • Control Activity D • Control Activity E	• Test A • Test D • Test E

Risk and Control Matrix – Results of Testing

- Reasonable results of testing should be assumed and documented.

Process-level Risk	Testing Approach	Results of Testing
Risk A – Definition (associated process-level objectives)	• Test A • Test B • Test C	• Result A • Result B • Result C
Risk B – Definition (associated process-level objectives)	• Test A • Test D • Test E	• Result A • Result D • Result E

Risk and Control Matrix – Testing Conclusions

- The conclusions should be appropriate based on the results of testing.

Process-level Risk	Results of Testing	Testing Conclusions
Risk A – Definition (associated process-level objectives)	• Result A • Result B • Result C	Conclusion covering Risk A
Risk B – Definition (associated process-level objectives)	• Result A • Result D • Result E	Conclusion covering Risk B

Potential Observations

- The observations will vary depending on the assumptions the students made. Make sure that the observations are supported by the design evaluation and testing results and are developed in the following format:

Condition: **Criteria:** **Cause:** **Effect:**

Instructor Note: The case facts are not clear relative to hourly worker pay rates that are a multiple of the worker's normal salary. These pay rates pertain to overtime worked, not for regular hours. For example, if a standard work week is 40 hours, the next 10 hours would be paid at standard rates, hours between 51 and 60 would be paid at time and a half, and hours in excess of 60 would be paid at double time.