



MAKING THE AUDIT UNIVERSE

In order to avoid an expectation gap, audit committees and internal auditors need to collaborate in determining the audit universe.

COMMON GROUND

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Almost universally, good governance practices call for public companies to have an internal audit department and for the audit committee and the chief audit executive (CAE) to meet on a regular basis as an important element of the governance structure. However, little guidance exists that explains what should be asked by the audit committee or reported by the CAE. AICPA guidance for the audit committee and IIA standards guiding internal audit reporting on fundamental issues leave plenty of room for information gaps.

The AICPA has provided guidance for audit committees to help them evaluate the performance and effectiveness of the internal audit team.¹ The audit committee is encouraged to ask questions about the internal audit plan and audit coverage.

Internal audit professionals have promoted their relationship with the audit committee with improved standards and practices. The IIA's Professional Practices Framework sets out in broad terms a set of standards and ethics, practice advisories, and development and practice aids to guide IIA members. These standards encourage internal audit independence and promote ongoing dialogue with the audit committee.

Very little guidance is provided in either document on the three most important

questions facing audit committees and internal audit departments, specifically:

1. Where and on what topics is assurance required?
2. How much assurance is enough?
3. What should be left off the audit plan, and why?

The document that answers these questions is typically called the audit universe.

There is virtually no definitive guidance for audit committees or internal auditors on how an audit universe should be defined and managed and only slightly more, but very traditional, guidance on how to select what to audit once the universe has been defined. Pre-existing guidance may be considered questionable in the post-Sarbanes-Oxley era.

The AICPA suggests that audit committees ask such questions as "Is the [internal audit] department's work planned appropriately?" when they assess the coverage provided by internal audit. No criteria are suggested for the audit committee to evaluate what is being planned by the CAE or what constitutes effective planning.

The IIA's Professional Practices Framework suggests, "The chief audit executive should establish risk-based plans to determine the priorities of the internal audit activity, consistent with the organization's

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EXHIBIT 1 The Top Ten End Result Objectives for Internal Audit: An Audit Committee Perspective

Audit Department Priority	Audit Committee Priority	End Result Objective
1	1	Ensure management personnel are aware of the current effectiveness of the systems of internal control in their area(s) and the risks being accepted by the organization.
4	2	Ensure the reliability and integrity of the financial, administrative, and operational information systems.
Not in Audit Dept. Top 10	3	Staff at all levels has a heightened awareness and understanding of the purpose and importance of internal controls.
2	4	Officers and the audit committee are provided with reliable information on the state of controls and risks across the organization.
Not in Audit Dept. Top 10	5	Minimize the magnitude and frequency of fraud against and/or on behalf of the company.
3	6	Company assets are adequately safeguarded.
Not in Audit Dept. Top 10	7	Delegated authority limits are being complied with.
Not in Audit Dept. Top 10	8	Confidence is increased that areas audited will be motivated to rectify any significant control deficiencies/risks.
6	9	Ensure the independence and objectivity of internal audit.
8	10	Confidence is increased that systems development projects follow an appropriate process and include appropriate internal controls.

goals.”² But CAEs are largely left to their own devices to apply this standard and to create an audit universe from it.

The result is that audit committees, senior management, and internal auditors themselves may have completely different assumptions about how the audit universe should be created, what entities should be audited or not audited, and what strategies are being employed by the internal audit department to provide the level of

assurance that the audit committee requires.

Better questions lead to better answers

Perhaps audit committees have not been asking enough questions and internal auditors have not been providing enough insight into these important areas.

Here is an actual example taken from our firm’s case files, based on a survey

EXHIBIT 2 Internal Audit Universe Scoping Tool by Objective Category

Category of Objectives	Include in I.A. Universe Yes / No	Assigned to Another Staff Group (Specify)	Management Report on Status (Specify)
1. Product Quality <ul style="list-style-type: none"> • Finished Product • System Development Projects • Raw Material Feedstock • Etc. 	No	Quality Control	
2. Customer Service	No	Marketing Services	
3. Minimizing Unnecessary Costs	No	No	Controller/Finance and Budgets
4. Reliable Business Information <ul style="list-style-type: none"> • Production Volumes • Order Backlog • Market Share • Etc. 	Yes		
5. Asset Safeguarding <ul style="list-style-type: none"> • Intellectual Property • Inventory 	Yes		
6. Safety	No	Safety	
7. Regulatory Compliance	Yes	Environment	
8. Fraud Prevention	Yes		
9. Continuity of Operations	No	Risk Management	
10. Internal Policy Compliance	Yes		
11. Contract Compliance	No	Procurement	
12. Reliable Financial Disclosure	Yes		

conducted for a client. The survey listed 22 potential objectives for the internal audit department and asked both the audit committee and internal audit management to independently rank the ten most important objectives from their perspectives. The table in Exhibit 1 compares their responses.

Alarming, of the ten objectives most important to the audit committee, four were not even on the top ten list of the internal audit department. Only one of the top ten objectives selected by the internal audit department, though thankfully their top priority objective, matched the priority assigned by the audit committee for this company.

Was this internal audit department's work appropriately planned? Arguably, yes, by the internal audit department's standards. Not surprisingly, however, it apparently was not the plan the audit committee wanted but had never asked for.

In the absence of any formal planning methodology, the chances of an internal audit department stumbling onto an audit universe that the audit committee truly expects, selecting the audits and assurance approach the audit committee wants, and reporting the results the audit committee needs are slim.

From the audit committee's perspective, there is little chance of being able to pro-

EXHIBIT 3 Internal Audit Universe Recommended Assurance Approach

Category of Objectives	Internal Audit of Control Effectiveness	Control Owner Survey	Risk and Control Self Assessment Workshop	Risk and Control Training
1. Product Quality <ul style="list-style-type: none"> • Finished Product • System Development Projects • Raw Material Feedstock • Etc. 	✓			
2. Customer Service			✓	
3. Minimizing Unnecessary Costs <ul style="list-style-type: none"> • Overtime Costs • Freight Costs • Energy Costs 				✓
4. Reliable Business Information <ul style="list-style-type: none"> • Production Volumes • Order Backlog • Market Share • Etc. 				✓
5. Asset Safeguarding <ul style="list-style-type: none"> • Intellectual Property • Inventory 	✓			
6. Safety			✓	
7. Regulatory Compliance				✓
8. Fraud Prevention	✓			
9. Continuity of Operations			✓	
10. Internal Policy Compliance		✓		
11. Contract Compliance	✓			
12. Reliable Financial Disclosure	✓			

vide the guidance, support, and oversight the internal audit department needs. The audit committee's resulting ability to rely on the work of internal audit is jeopardized.

Many audit departments organize their audit universes around the organizational hierarchy. This has the apparent advantage of ensuring complete coverage, at least in an organizational sense, and provides an

accountability framework both for approving the audit plan and for issuing audit reports and resolving findings. But on its own, as the survey results in Exhibit 1 suggest, it does not provide either the audit committee or internal audit with the necessary assurance that their expectations are being met. That confidence can only come when agreement is reached on the specific objec-

tives the audit committee has in mind for internal audit. Put another way, “What does the audit committee want assurance on and who do they want to provide it?”

For example, scheduling the internal audit of a subsidiary to ensure that purchase order authority levels are complied with when the audit committee expects assurance that the operating statistics in the MD&A are reliable represents a conflict in expectations. To avoid such conflicts, it is necessary to define not only the entity to be audited, but also the objectives the entity is responsible for on which assurance is required.

The audit universe can be defined in terms of both objectives and entities, and an audit plan created accordingly. Some entities will be responsible for many objectives, any or all of which may be in scope for internal audit. Other entities will have few, if any, objectives considered by the audit committee to be within the mandate of internal audit. IIA Practice Advisory 2010-2, “Linking the Audit Plan to Risk and Exposures,” suggests that “by incorporating components of the organization’s strategic plan, the audit universe will consider and reflect the overall business’ objectives.”³

Developing the audit universe

Exhibit 2 illustrates the use of broad categories of objectives to define internal audit’s scope. This format allows the audit committee to clearly indicate what they hold internal audit accountable for as an assurance provider and what objectives they expect other groups, such as safety and environmental compliance, to provide assurance on. Assigning management or another group the direct accountability for providing assurance does not necessarily eliminate internal audit’s role. Management or the audit committee may request internal audit to provide an opinion on the reliability of the work of the primary assurance provider.

Developing an appropriate assurance strategy

Once the audit universe has been determined and agreed upon with the audit committee and management, the appropriate assurance strategy can also be determined.

Internal auditors must lead this discussion. Just as a patient must rely on his or her medical doctor to determine a treatment plan, the audit committee must rely on the CAE to decide on the assurance approaches that are available. But, like a good doctor, the CAE should explain the choices, their costs, and their benefits, and make a recommendation. A chart showing recommended assurance approaches for the internal audit universe is included in Exhibit 3.

JUST AS A PATIENT MUST RELY ON HIS OR HER MEDICAL DOCTOR TO DETERMINE A TREATMENT PLAN, THE AUDIT COMMITTEE MUST RELY ON THE CAE TO DECIDE ON THE ASSURANCE APPROACHES THAT ARE AVAILABLE.

The IIA standards recognize a variety of approaches for providing assurance. The days when the job of the internal auditor was merely to perform internal audits are long gone. Internal auditors may be called upon to provide training, to perform consulting assignments, to conduct high-level risk assessments, or to facilitate control self-assessment workshops, for example. The audit committee should be aware of all of the tools in the internal audit toolkit.

A variety of factors will influence the choice of assurance approaches, including the relative strategic importance of the specific objective or objective category, the actual performance of the organizational entity in achieving the objective, and the complexity of the objective.

Fostering collaboration

Audit committees are thirsty for information on internal control and often eager to participate in a positive relationship with internal audit. But they often do not know what to expect from the company’s CAE or what questions to ask.

Internal audit, while wishing to maintain its independence and objectivity, needs the support and guidance of the audit committee. In the absence of specific direction, internal auditors might simply continue to report exceptions and significant findings.

In the past, many audit committees were satisfied to simply ask the CAE “Is every-

thing under control?” The CAE would usually answer with the expected “yes” or possibly with a couple of exceptions.

Good audit committees will always want to know if everything is “under control,” but they need to ask, and internal auditors need to tell them, how internal auditors determine the answer and just how true the answer is on an objective-by-objective basis. ■

NOTES

- ¹ See AICPA, *Audit Committee Toolkit*, “Evaluating the Internal Audit Team: Guidelines and Questions,” available online at www.aicpa.org/audcommctr/toolkitscorp/15.htm (accessed August 2006).
- ² The Institute of Internal Auditors (IIA), Professional Practices Framework, Performance Standard 2010, “Planning,” available online at www.theiia.org/index.cfm?doc_id=1617 (accessed August 2006).
- ³ The Institute of Internal Auditors, Professional Practices Framework, Practice Advisory 2010-2, “Linking the Audit Plan to Risk and Exposures” (March 7, 2001).