# Supplemental Guidance: Implementing a New Internal Audit Function in the Public Sector

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Executive Summary

This paper addresses the key points and steps a newly appointed chief audit executive (CAE) should consider to ensure that his or her new internal audit department improves governance, risk management, and internal controls processes, and thereby adds value to its public sector organization. Another goal of this paper is to enable a public sector internal audit function to move quickly from levels 1 and 2 to level 3 of the Internal Audit Capability Model (IA-CM).

With these purposes in mind, the paper’s guidelines follow a fundamental business model divided into three important components: Organizing, Managing, and Controlling.

The Organizing component addresses the tasks of:

- Researching the legal basis of internal audit within the government jurisdiction.
- Formalizing an internal audit charter.
- Placing the internal audit function at the appropriate level within the organization.
- Formulating a strategic plan.
- Selecting appropriate audit standards to follow.
- Defining the audit universe/horizon.
- Hiring staff, identifying needed competencies, creating job descriptions, and identifying appropriate pay levels.

The second component of the business model, Managing, covers planning and conducting audit and consulting engagements, supervision, workpaper documentation, and communicating results.

The third component, Controlling, guides the CAE in establishing a quality assurance and improvement program (QAIP).

Finally, the last section of this paper provides a list of practical steps and a time line for creating a new internal audit function in a public sector organization. This practical advice was gathered from experts with firsthand experience in public sector auditing. The suggested schedule includes three sections: the first six months, from six months to approximately one year, and continuous/ongoing.
Introduction

You have been appointed as the CAE\(^1\) of a recently established internal audit function or as CAE of an ill-functioning internal audit function in any type or level of public sector branch or entity. You now face the sometimes daunting task of having to prepare your department to respond to the increasing challenges and demands for transparency, accountability, and effectiveness at all levels of government. (The authors have assumed that the appointed CAE not only understands internal audit standards, but also has the skills, subject matter expertise, and general management perspective to effectively lead an internal audit function within a public sector entity.)

This paper addresses the key points and steps for a CAE or an executive manager to analyze and implement in preparing his or her internal audit department to improve the entity’s governance, risk management, and internal control processes, and thereby add value to the organization. Furthermore, the paper cites research and publications from recognized authors and organizations as references for public sector managers and CAEs to provide their internal audit function with essential tools and resources.

The points covered in this paper are linked to The Internal Audit Capability Model (IA-CM) for the Public Sector, developed by The Institute of Internal Auditors Research Foundation (IIARF). Because the key factors to establishing an adequate infrastructure for the internal audit department and to integrating its functions into the organization are suggested, this document is also a guide to help CAEs and executive managers advance the internal audit function to level 3 of the IA-CM.\(^2\)

In addition to reviewing currently available literature and relating the actions needed to implement steps and processes, a great deal of practical experience and information was collected by interviewing or corresponding with people having firsthand experience creating new and/or transforming existing internal audit functions within different types and levels of public sector organizations in several countries.

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\(^1\) For the preferred qualifications of a CAE, see The Institute of Internal Auditors’ Practice Guide, Chief Audit Executives: Appointment, Performance Evaluation, and Termination. For more information about CAE qualifications consult The IIA’s website at www.globaliia.org for the Competency Framework.

\(^2\) See Appendix: The Internal Audit Capability Model for the Public Sector, “Internal Audit Capability Model Matrix.”
Generally, people consulted agreed on the most common actions to follow. There was some variety of opinions regarding the importance or actual sequence of actions. Variations also occurred due to differences in resources (both staff and funding) available. The public sector internal audit functions consulted varied in size from one to 65 employees.

Additional contributions to this material came in the form of copies of PowerPoint presentations, comments, edits, additions, explanations, and clarifications from a group of experts with global audit experience.
Challenges to Implementing a New Internal Audit Function in the Public Sector

The experts consulted agreed that access to adequate human resources such as a legal advisor, an administrative assistant, and, if appropriate to the size of the organization, a chief deputy auditor was essential early on. Those personnel would assist the CAE in addressing the most urgent organizational and management issues and allow the CAE to prepare, plan, and implement the new internal audit function.

One of the biggest challenges in the public sector is the allocation of an adequate budget for the internal audit function. Intense competition for limited resources, political pressures, and taxpayers' demands for increased efficiency in government, lower costs, and lower taxes are all monetary challenges. Political pressures can also arise, threatening the independence and objectivity of the internal audit function.

To mitigate these challenges, CAEs should consider the following activities:

- Interviewing senior managers, stakeholders, and appointing authorities to learn what they expect from an internal audit function.
- Educating senior managers and appointing authorities on the role of internal audit.
- Ensuring that the internal audit function reports within the organization to a sufficiently high-level official, the audit committee, or another governing body.
- Marketing the internal audit program throughout the organization.
- Soliciting input and feedback from employees at all levels of the organization.
- Preparing frequent, regular written reports for the executive manager and a summary for the governing body and/or audit committee.
- Soliciting and obtaining citizen input.
- Remaining flexible and ready to continuously adapt to change.
The Internal Audit Capability Model Applied to New Internal Audit Functions

The IA-CM identifies different levels of internal audit functions in either the private or public sector. The progression from lower to higher levels is an assessment of the maturity and complexity of the internal audit activity and/or the organization it serves.

The IA-CM describes five levels of internal audit activity in accordance with its set of capabilities. On lower levels (1 and 2), capabilities are characterized by the absence of infrastructure, lack of adherence to established professional practices or partial compliance with professional standards, reliance on personal skills to perform engagements, and audit planning based on management priorities, among other factors.

On higher levels (3, 4, and 5), capabilities are characterized by compliance with professional standards; focus on independence and objectivity; documentation of processes, policies, and procedures; quantitative measurement and management of risk; participation in the organization’s governance and risk management; and transformation into a learning organization with continuous process improvements and innovation.

Specifically, level 3 (integrated) audit functions are characterized by the following set of capabilities:

3 – INTEGRATED

- Internal audit (IA) policies, processes, and procedures are defined, documented, and integrated into the organization’s infrastructure.
- IA management and professional practices are well established and uniformly applied across the IA activity.
- IA is starting to align with the organization’s business and the risks it faces.
- IA evolves from conducting only traditional audits to integrating as a team player and providing advice on performance and management of risks.
- Focus is on team building and capacity of the IA activity and its independence and objectivity.
- Generally conforms to The IIA’s International Standards for the Professional Practice of Internal Auditing (Standards).

The recommendations included in this paper describe the steps in helping a public sector internal audit function move from levels 1 and 2 to level 3.

3 See Appendix B: The Internal Audit Capability Model for the Public Sector for the IA-CM levels.
Fundamental Business Model — Organizing, Managing, and Controlling

It is commonly recognized that most literature on internal audit and auditing in general is derived from private sector experience and that the literature based on public sector experience is scarce. The public sector has its own unique features. However, it makes sense to use and adapt the literature focused on private sector experience as a guide for CAEs and public sector managers to establish new internal audit functions.

The reason for this is that most of the guidelines available are based on universal management, internal control, and governance principles that can be applied to virtually all types of organizations whether public or private, for profit or not-for-profit.

To organize the issues addressed and help CAEs think about their audit departments, the guidelines are divided into three fundamental parts:

1. Organizing – deals with strategy and empowerment of the internal audit function, and it defines the kinds and the extent of resources needed to manage the whole function.
3. Controlling – deals with the assurance that the function is fulfilling the organization’s needs and expectations.

This widely known and recognized business model (Dubrin, 1999, Dessler, 2000, and Griffen, 2002) was originally adapted by Douglas Prawitt for a study sponsored by The IIARF.

Organizing the Internal Audit Function

Researching the Legal Basis

On a broad, international perspective, the authority for internal audit may be established through a variety of legal instruments. As with most public sector functions, internal audit often has a legally based authority that should be fully researched and understood by the CAE.

Some countries with stricter legal cultures formally reference the internal audit function in their constitution, either federal or state, prior to the promulgation of specific laws.

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In civil and common law countries, public sector internal audit is often authorized by specific legislation. In some jurisdictions there are additional regulations. On the local government level there are often specific ordinances for internal audit.

Need for a Charter
The second step is to provide an organizational framework so that the audit department improves its chances of contributing effectively to the achievement of the organization’s mission, goals, and objectives.

- Regardless of the jurisdiction where the organization operates — i.e., common law countries or civil law countries — it is important that the purpose, authority, and responsibility of the internal audit function are formally defined in a charter.
- The IIA’s International Professional Practices Framework (IPPF), through Standard 1000: Purpose, Authority, and Responsibility, prescribes that:

“The purpose, authority, and responsibility of the internal audit activity must be formally defined in an internal audit charter, consistent with the Definition of Internal Auditing, the Code of Ethics, and the Standards. The chief audit executive must periodically review the internal audit charter and present it to senior management and the board for approval.”

Internal Audit Function and CAE Require Adequate Status Within the Organization and Organizational and Political Independence
Given the comprehensiveness and complexity of internal audit activities, the department should have the requisite status within the organization — otherwise other departments or functions may not cooperate with the internal audit function. It is a primary concern to provide adequate, necessary status to the internal audit function. Therefore the internal audit function should report directly to the appointing authority, the agency head, or the governing body through the audit committee.

In countries where audit committees are not commonly found in public sector organizations, or where the organization is not run by a governing body, it is imperative that the internal audit function at least report to the highest management official within the organization.

The internal audit activity should encompass every part of the organization’s operations, and to this end it should have unlimited access to the organization’s personnel, documents, records, and properties.
Along with the appropriate level of organizational status, the internal audit department should have organizational independence. This means that the internal audit function should not have any direct relationships with the departments and/or functions that it will be auditing.

It is imperative, particularly in political entities where the CAE reports to management or a legislative committee, city council, etc., that the CAE not be limited to a specific term of office. Otherwise, the CAE could simply be dismissed when his or her term ends. It is recommended that the CAE be appointed to his or her position and that a super majority vote of the audit or legislative committee is required for CAE termination.

The internal audit charter provides the internal audit function with a formal mandate to do its work. It should define the following items with respect to the internal audit function:5

- Establish the position of the internal audit department within the organization and define the scope and nature of its activities.
- Authorize the internal auditors’ access to, among other things, all records, personnel, and property needed to accomplish audit and consulting projects.
- Grant the CAE the authority to allocate resources, establish schedules, determine the scope of audit work, and set audit objectives, without undue interference from management.
- Clearly outline the department’s reporting structure, giving the CAE full and unrestricted access to the audit committee or top organization official.
- Clearly communicate that the purpose of the internal audit activity is to serve the organization by evaluating the effectiveness of risk management, control, and governance processes consistent with The IIA’s Definition of Internal Auditing, Standards, and Code of Ethics. This also includes coordinating internal audit activities with others to achieve the most effective and efficient results.
- Delineate the specific responsibilities of the CAE and the staff, such as to create and submit to the board for review and approval an annual audit plan developed using an appropriate risk-based methodology.

**Establishing a Strategic Plan**

- It is of utmost importance for every initiative that managers have a structured

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notion of a business’s position within its industry. The same applies to a CAE with regard to his or her audit department within its public sector organization.

- There are many frameworks to help CAEs establish an adequate strategic plan for the internal audit function. There are various tools on the market to assist CAEs in this challenging task.  
- These tools help structure thinking about the mission, goals, objectives, and outcomes that shape the business of the public sector entity, and therefore help the CAE facilitate development of a strategic plan for the internal audit function that aligns with the organization’s strategic plan.
- At the very least the initial internal audit function’s strategic plan should include a vision, mission, core values, goals, and objectives with appropriate measures to determine progress and achieve success.

**Identify the Appropriate Audit Standards to Follow**

- The CAE should choose the correct audit standards to guide the work of the internal audit function.
- Standards are important because they serve as the first layer of the quality assurance process.
- In the public sector, internal audit standards are often stipulated in laws and/or regulations, and therefore are mandatory.
- Given the cultural, social, economic, political, legal, and even religious differences around the world, it is difficult to address the specificities of each country or each state or local government inside a given country to provide unique guidance on how to choose an appropriate audit standard.
- Recognition by the auditees and the organization as a whole that the internal audit function follows legal and/or global professional guidance in conducting its work enhances the credibility of its reports and conclusions. Therefore, it is crucial for CAEs to search for a framework that is appropriate to the local environment in which the internal audit function operates.
- The IIA’s IPPF, also known by some as the Red Book, should be considered as the guide for best practices when they do not conflict with, and are complementary to, any mandatory standards.
- In countries without any national internal audit framework, and for those countries without a mandatory set of internal audit standards, the IPPF should be the preferred standards adopted by internal auditors working in the public sector.

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Defining the Audit Universe/Horizon

- The definition of an audit universe for internal audit functions in the public sector may sometimes, in civil law countries, be included in specific laws or acts. In these cases, the problem is one of prioritization of audit objectives because the universe is governed by laws and regulations.
- Therefore, prioritizing audit objectives is best achieved in the planning phase, detailed in the “Managing the Audit Function” section below.
- The audit horizon issue should also be appropriately undertaken in the planning phase described above.

Hiring Staff

- The internal audit activity requires personnel from diverse backgrounds and different levels of experience.
- As pointed out by Richard Anderson (2001)\(^7\), before engaging in the hiring process the organization should define the size of its internal audit function. Smaller departments will necessarily have to rely on more experienced auditors while larger ones will benefit from a blend of newcomers, seniors, and people from different academic and professional backgrounds.
- Recognizing the extensive range of services provided by the internal audit function, IIA Standard 1210: Proficiency states, “Internal auditors must possess the knowledge, skills, and other competencies needed to perform their individual responsibilities. The internal audit activity collectively must possess or obtain the knowledge, skills, and other competencies needed to perform its responsibilities.”
- As a starting point and as a reference for managers and CAEs to identify the skills involved in the internal audit activity, The IIA published a set of documents known as the Competency Framework for Internal Auditing (CFIA).

Examples of required competencies include:

A. Proficiency in applying internal audit standards, procedures, and techniques. Proficiency means the ability to apply knowledge to situations likely to be encountered and to handle them without extensive technical research or assistance.

B. Proficiency in accounting principles and techniques. Auditors who will work extensively with financial records and reports should be proficient in those areas.

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C. An understanding of management principles that enables auditors to recognize and evaluate the materiality and significance of deviations from sound business practices. An understanding means the ability to apply broad knowledge to situations likely to be encountered, to recognize significant deviations, and to carry out the research necessary to arrive at reasonable solutions.

D. An appreciation of the fundamentals of subjects such as accounting, economics, commercial law, taxation, finance, quantitative methods, and IT. An appreciation means the ability to recognize the existence of problems or potential problems and to determine when further research should be undertaken or when to obtain expert assistance.

E. In addition, internal auditors should be skilled in dealing with people and in communicating effectively both orally and in writing.

F. Another much appreciated skill is computing proficiency.

**Accreditation, Certification**

Accreditation can also be an important indicator of an auditor’s technical proficiency. Certifications that have been recognized as showing technical proficiency useful in internal audit include: Certified Internal Auditor® (CIA®); Certified Public Accountant (CPA) or international equivalent (e.g., Chartered Accountant); Certified Management Accountant (CMA), Certification in Risk Management Assurance™ (CRMA™), Certified Information Systems Auditor (CISA) and, especially for the public sector, Certified Government Auditing Professional® (CGAP®) and Certified Government Financial Manager (CGFM)\(^8\).

**Develop Job Descriptions**

Another important step in the hiring process is to develop detailed job descriptions for each position in the internal audit department; identifying the skills, knowledge, and abilities required; and the respective pay grades. An excellent resource to help in structuring job descriptions can be found in Birkett et al. (1999)\(^9\).

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\(^8\) For more information about the CIA, CGAP, and CRMA certifications, consult The IIA’s global website at www.globaliia.org. See the websites of the American Institute of Certified Public Accountants for CPA, Association of Government Accountants for CGFM, Association for Accountants and Financial Professionals in Business for CMA, and ISACA for CISA.

Managing the Internal Audit Function

Once the authorities, responsibilities, and purpose of the internal audit function are formalized, its size defined, and the appropriately experienced and skilled staff has been hired, it is time to turn to the daily operations and activities.

Risk-based Audit Plans and Individual Engagement Audit Planning

Planning the audit activities is clearly the first step. However, it is not always clear to CAEs and managers of small agencies’ internal audit departments that there is a distinction between planning the whole internal audit function’s activities and planning individual audit engagements. If the main purpose of an audit department is to help the organization achieve its mission, goals, and objectives, then recognizing and addressing the risks that may prevent the entity from achieving its goals is of the utmost importance.

Developing Annual Risk-based Audit Plans for the Whole Internal Audit Activity

IIA Standard 2010: Planning states, “The [CAE] must establish risk-based plans to determine the priorities of the internal audit activity, consistent with the organization’s goals.”

To increase the probability of success in designing a risk-based audit plan, the use of a more formal approach is recommended. The IIA's website is a key resource in the search for tools for a more structured approach. For example, a number of training courses are available on this topic. The CGAP and the recently launched CRMA certifications are excellent tools to equip members of the audit management team with the appropriate skills to develop risk-based audit plans.

Understanding The Committee of Sponsoring Organizations of the Treadway Commission’s (COSO’s) Enterprise Risk Management – Integrated Framework is also helpful in recognizing the organization’s internal control risks and identifying areas to be audited.

The CAE and management’s comprehensive assessment of all the organization’s risks helps them prioritize where to focus audit resources. The resulting audit plan is subject to continuous reassessment as new risks and priorities emerge.

Nevertheless, other factors besides risk will influence the decision of which areas to audit:

- Changing circumstances in the business, operations, programs, systems, or controls.
• Changes in the risk environment.
• The potential benefit(s) to be achieved from the engagement.
• Changes in the skills of the available staff, because new skills may enable the internal audit function to conduct different types of engagements.
• Requests from external auditors, senior management, or other governing bodies.

**Developing Individual Engagement Plans**

In addition to the risk-based audit plan, The IIA’s Standard 2200: Engagement Planning says, “Internal auditors must develop and document a plan for each engagement, including the engagement’s objectives, scope, timing, and resource allocations.”

During the process of planning for the engagement, based on Standard 2201: Planning Considerations, internal auditors must consider:

• The objectives of the activity reviewed and the controls in place to regulate its performance.
• The significant risks to that activity, its objectives, resources, and operations, and the means by which potential impact of risk is kept to an acceptable level.
• The adequacy and effectiveness of the activity’s risk management and control processes compared to a relevant control framework or model.
• The opportunities for making significant improvements to the activity’s risk management and control processes.

The IIA’s Practice Advisory 2200-1: Engagement Planning summarizes the methodology and approach for conducting competent individual engagement planning.

**Conducting Engagements: Gathering Sufficient, Reliable, Relevant, and Useful Information**

Executing the engagements is the natural result of planning. The related IIA standards are 2300: Performing the Engagement, 2310: Identifying Information, 2320: Analysis and Evaluation, 2330: Documenting Information, and 2340: Engagement Supervision.

According to standards 2300 and 2310:

• Internal auditors must identify, analyze, evaluate, and document sufficient information to achieve the engagement objectives.
• Internal auditors must identify sufficient, reliable, relevant, and useful information to achieve the engagement’s objectives.
In auditing, sufficient evidence means “enough” evidence. The auditor should collect enough information so that another auditor who looks at the collected information would reach the same conclusion given the set of evidence collected.

Relevance relates to reliability of information. The best expression for describing the reliability of evidence is competence. Competent evidence means that it truly substantiates the conclusion(s) it seems to support.

One of the main factors in determining the sufficiency and the relevance of evidence is the reliability of the source of information. As a rule of thumb, the most objective source of evidence is the auditor. Original evidence gathered directly by the auditor is usually the most reliable. Evidence provided by the client should be validated with corroborating evidence.

The strength of the sufficiency and the reliability of evidence gathered increases the credibility of the information used to draw conclusions from the engagement.

Relevant evidence means that it has to be related to the audited item and that it answers the questions in the engagement planning phase.

Useful evidence allows the organization to meet its goals. This process of gathering useful evidence is one of the most important roles of the internal audit function.

Standard 2320 states, “Internal auditors must base conclusions and engagement results on appropriate analyses and evaluations.”

This standard refers to the collection of evidence that will support the conclusion. The two main types of audit tests employed to collect information are analytical procedures and tests of details.¹⁰

**The Importance of Supervision**

Audit supervision is a crucial phase of the engagement process because it has a direct impact on the collection of evidence. The more efficient the supervision, the more effective the collection of evidence — thereby making the conclusion process proceed smoothly.

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According to Practice Advisory 2340-1, engagement supervision is “a process that begins with planning and continues throughout the engagement.”

The process includes, among other activities:

- Ensuring designated auditors collectively possess the required knowledge, skills, and other competencies to perform the engagement.
- Providing appropriate instructions during the planning of the engagement and approving the engagement program.
- Ensuring the approved engagement program is completed unless changes are justified and authorized.
- Determining engagement working papers adequately support engagement observations, conclusions, and recommendations.
- Ensuring engagement communications are accurate, objective, clear, concise, constructive, and timely.
- Ensuring engagement objectives are met.
- Providing opportunities for developing internal auditors’ knowledge, skills, and other competencies.

Adequate supervision ensures that documentation meets internal audit standards.

**Workpaper Functions**

Documenting the engagement is a fundamental part of audit work because all of the conclusions stated in the report should be supported by the workpapers.

Practice Advisory 2330-1: Documenting Information outlines the functions of workpapers, which should:

- Aid in the planning, performance, and review of engagements.
- Provide the principal support for the engagement results.
- Document whether the engagement objectives were achieved.
- Support the accuracy and completeness of the work performed.
- Provide a basis for the internal audit activity’s quality assurance and improvement program.
- Facilitate third-party reviews.
Communicating Results

A further step in the engagement process is communicating the results.

The relevant standards in this matter are 2400 to 2440.C2. Below is an outline of the most critical aspects of communicating the results required by the Standards:

**Standard 2420: Quality of Communications — “Communications must be accurate, objective, clear, concise, constructive, complete, and timely.”**

Interpretation:

- Accurate communications are free from errors and distortions and are faithful to the underlying facts.
- Objective communications are fair, impartial, and unbiased and are the result of a fair-minded and balanced assessment of all relevant facts and circumstances.
- Clear communications are easily understood and logical, avoiding unnecessary technical language and providing all significant and relevant information.
- Concise communications are to the point and avoid unnecessary elaboration, superfluous detail, redundancy, and wordiness.
- Constructive communications are helpful to the engagement client and the organization and lead to improvements where needed.
- Complete communications lack nothing that is essential to the target audience and include all significant and relevant information and observations to support recommendations and conclusions.
- Timely communications are opportune and expedient, depending on the significance of the issue, allowing management to take appropriate corrective action.

Disseminating results is an important phase of the communicating phase (Standard 2440).

The Exit Interview

Although the final communication should be issued by the CAE, the internal auditor should adopt the best practice of discussing conclusions and recommendations with the appropriate levels of management of the engagement client before the final communication is issued.
An exit interview is the preferred method of communication. One purpose of this meeting is to ensure that there have been no misinterpretations or misunderstanding by the auditor(s).

The discussions at the exit interview should be documented and be part of the final communication.

**Follow-up and Monitoring Engagements**

Last but not least comes the monitoring phase of the engagement.

The relevant IIA standard is 2500: Monitoring Progress. Practice Advisories 2500-1 and 2500.A1-1 provide details of the process.

Follow-up is defined by Practice Advisory 2500.A1-1 as “A process by which internal auditors evaluate the adequacy, effectiveness, and timeliness of actions taken by management on reported observations and recommendations, including those made by external auditors and others. This process also includes determining whether senior management and/or the board have assumed the risk of not taking corrective action on reported observations.”

Furthermore, according to Practice Advisory 2500.A1-1, the nature, timing, and extent of follow-up should be determined by the CAE after consideration of the following factors:

- Significance of the reported observation or recommendation.
- Degree of effort and cost needed to correct the reported condition.
- Impact that may result should the corrective action fail.
- Complexity of the corrective action.
- Time period involved.

**Controlling the Internal Audit Function**

**Establish a Quality Assurance and Improvement Program (QAIP) —**

**The Importance of a Quality Assurance and Improvement Program**

As stated by Griffen (2002),11 “Control is the regulation of organizations’ activities so that targeted elements of performance remain within acceptable limits.”

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- According to the Standards, “The CAE must develop and maintain a quality assurance and improvement program that covers all aspects of the internal audit activity.”

This type of program includes periodic internal and external quality assessments and ongoing internal monitoring. The program is designed to help the internal audit activity add value and improve the operations of the organization and to provide assurance that the activity is in conformance with the Standards.

Based on Practice Advisory 1310-1, quality program assessments include the evaluation of:

- Conformance with the Definition of Internal Auditing, the Code of Ethics, and the Standards, including timely corrective actions to remedy any significant instances of nonconformance.
- Adequacy of the internal audit activity’s charter, goals, objectives, policies, and procedures.
- Contribution to the organization’s governance, risk management, and control processes.
- Compliance with applicable laws, regulations, and other government or industry standards.
- Effectiveness of continuous improvement activities and adoption of best practices.
- The extent to which the internal audit activity adds value and improves the organization’s operations.\(^{12}\)

\(^{12}\) For further information on quality assurance and improvement programs, consult the “Quality” section on The IIA’s website, www.theiia.org.
Suggested Practical Steps and a Time Line to Follow When Implementing and Creating an Internal Audit Function in a Public Sector Organization

The information in this section came exclusively from person-to-person interviews with individuals with firsthand experience establishing an internal audit function in a public sector organization.

First Six Months — Actions Needed

1. All the interviewees, contributors, and reviewers generally agreed that the CAE should obtain the services of an administrative assistant as early as possible, and, if the size of the organization warrants, a chief deputy auditor.

2. It is also important at this stage for the CAE to obtain and establish a relationship with any legal advisor who is available to him or her within the public sector organization.

3. Some basic equipment, reference materials, and software should be purchased for the initial employees.

All agreed that the CAE, possibly with the assistance of a deputy, should be the person to actually perform the following activities. It is essential that the CAE have confidence in the information collected; moreover, these activities are important to opening lines of communication, establishing relationships, and providing a basis for the CAE to prepare and plan the future of the internal audit function.

4. Research the legal basis for the creation of the internal audit function and the appointment of the CAE. It is essential that this research not be limited to just local legislation, but also any other state, provincial, regional, national, or international legislation applicable. This may affect/determine reporting relationships, required qualifications of CAE and staff (such as certifications), conditions for termination, reporting relationships, whether or not an audit committee is established, the composition of the audit committee, etc.

5. Determine the audit standards that will be followed by the organization. For example, in the United States, government audits are performed in accordance with the U.S. Government Accountability Office’s Government Auditing Standards (the “Yellow Book”); government auditors in the United Kingdom comply with the HM Treasury’s Government Internal Audit Standards; and in the Canadian Auditor General’s Office, government auditors perform in accordance
with the Office of the Auditor General’s Comprehensive Auditing Manual. In addition, many public sector audit groups are members of the International Organization of Supreme Audit Institutions (INTOSAI), and thus adhere to the audit standards promulgated by INTOSAI. In the European Community, many countries follow the principles outlined in Public Internal Financial Control (PIFC).

6. Consider adopting the organizational structure suggested by PIFC with a central harmonization unit (CHU) within the central internal audit function as a focal point to coordinate audit activities with the external auditor. Also, the CHU would be responsible for coordinating internal audit training with decentralized internal audit functions and internal control training with line ministers throughout the organization.

7. Define the audit universe.

8. Interview senior managers and appointing authorities to learn what they expect from an internal audit function.
   a. Learn processes being used.
   b. Evaluate internal controls.
   c. Identify common themes of concern.

9. Educate senior managers and appointing authorities about the role and methods of internal audits, Standards, different types of audits, internal controls, etc.

    a. Prioritize risks and identify those that can be addressed quickly to establish the benefit of an internal audit function.
    b. Determine the organization’s risk appetite.

11. Write the audit charter; get approval from management and council or the audit committee.

12. Develop a mission, vision, core values, and a strategic plan.

13. Based upon the initial risk assessment, develop a draft audit plan; the initial draft plan may or may not be distributed. At a minimum, the draft audit plan should be coordinated with the external auditors to avoid duplication of effort to the maximum extent possible.

14. Determine audit capacity and relate it to the audit work plan. Estimate the resources (staff and funding) required to execute the draft audit plan.
Six Months to One Year or Longer — Actions Required

The first year is basically a “test period” — management is trying you out; the CAE is “selling” the program. The appointing authority and/or audit committee may require a faster implementation schedule, causing some of the items listed below to be implemented during the first six months.

1. Formulate and get the start-up budget approved.
2. Propose an estimated annual budget based upon resources allocated (number of employees, job classifications, administration, audit operations, outside consulting needs, training needs, etc.)
3. Begin writing an audit manual; if the size of the organization allows, enlist the deputy and/or a senior auditor to assist in manual development.
4. Develop detailed job descriptions with salaries appropriate to skills and experience.
5. Begin search for experienced audit employees for senior team leaders.
6. Develop a training program and hire the senior staff that will train new employees and lead initial audits.
7. Purchase the tools and equipment (especially laptops and software) necessary to perform the internal audit function.
8. Begin to conduct internal audits and implement the audit plan.
9. Establish a QAIP.
10. Lay the groundwork to purchase computer-assisted audit software, such as data analysis applications, to help the internal auditors quickly identify potential problem areas.
11. Implement a formal employee training and development plan based upon a skills assessment.
12. Continue efforts to establish an independent internal audit function with oversight by a sufficiently high-level official, oversight body, or audit committee.
13. Continue efforts to establish a CHU, as presently being adopted throughout the European Community.
14. Establish ongoing outreach, input, and communication between the internal audit function and government entity managers and employees.
   a. Establish continuous, ongoing marketing of the internal audit program.
   b. Solicit input and feedback from government entity staff.
   c. Prepare a monthly written report for the executive manager with a maximum two-page summary for the council and/or audit committee.
   d. Issue a quarterly newsletter for senior managers on the internal audit function.
e. Create a website to publish the current audit plan and post final audit reports; obtain citizen input; etc.
15. Establish ongoing relationships with managers, council, and the audit committee.
16. Establish relationships with external auditors.
17. Create database(s) to track the status of corrective actions and follow-up on audits issued.

Continuous/Ongoing

1. Maintain relationships.
2. Sit in on management committee meetings.
4. Continuously update the audit plan.
5. Try to minimize political pressures and influences on the internal audit function and CAE.
6. Be flexible and adapt to change.
7. Implement an internal QAIP and external quality assurance review (QAR). Follow up to continuously improve the internal audit function.
8. Undergo continuous development to meet professional standards.
9. Make continuous improvements by researching and adopting best practices and benchmarking with world-class organizations.
Conclusion

The purpose of this document is to provide a newly appointed CAE with best practices and other information to implement a new internal audit function — or improve a noncomplying function — within a public sector organization. This document is intended to serve as practical, step-by-step advice. It summarizes the standards, staffing, and resources needed to successfully plan and implement or improve an internal audit function in the public sector for the first two-plus years. Not only does this material provide a comprehensive theoretical framework, but it also provides the CAE with a chronological list of the order in which things should ideally occur.

It is a compilation of a review of existing literature, applicable guidance from the IPPF, and practical advice from experts who have actually been through the experience. It is intended to help CAEs avoid possible pitfalls and missteps. The CAE begins by following a business model divided into three fundamental parts: organizing, managing, and controlling. It ends with a chronological list of steps to be considered and/or taken.

If all of the suggested steps and standards are followed, the CAE will implement a comprehensive and complete public sector internal audit function ready for a QAR when timely. He or she should also within the first two-plus years move quickly from levels 1 and 2 to level 3 of the IA-CM.
About the Authors, Contributors, and Reviewers

Authors
Gualter Portella, CIA, CGAP
Christie J. O’Loughlin, CGAP

Contributors and Reviewers
Paul J. Duggan, CA, CIA, CISA (Director of Audit Services, Regional Municipality of York, Province of Ontario, Canada)
Scottie Nix, CIA (City Auditor, Tacoma, Washington)
Harriet Richardson, CPA, CIA, CGAP (former Deputy City Auditor, Atlanta; also the City of San Francisco, and the Washington State Auditor’s Office while it implemented a new performance audit function)
Susan Cohen (the former City Auditor, Seattle)
Jesse W. Hughes, Ph.D., CPA, CIA, CGFM (Professor Emeritus, Old Dominion University, Norfolk, Virginia, with extensive international audit experience)
Daniela Danescu, CIA, CGAP (an internal audit consultant from the Netherlands with background working for the Romanian government)
Steve Goodson, CIA, CISA (CAE at the Texas Department of Public Safety)
Elizabeth (Libby) MacRae, CGAP
Kenneth J. Mory, CIA, CPA, CISA (City Auditor, Austin, Texas)
Greg Hollyman, CGAP, CFSA, CFE, CISA, CCSA, CIA, (former CAE of the City of Johannesburg, former CAE at South African Post Office, former CAE at City of Port Phillip, and Audit Committee Member at City of Whitehorse)
Josh Richardson, CIA, CFE, CISA (Internal Audit Director, Oklahoma Teachers’ Retirement System)
Appendix – Sample Internal Audit Activity Charter

Mission and Scope of Work

The mission of the internal audit department is to provide independent, objective assurance and consulting services designed to add value and improve the organization’s operations. It helps the organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of governance, risk management, and control processes.

The scope of work of the internal audit department is to determine whether the organization’s network of governance, risk management, and control processes, as designed and represented by management, is adequate and functioning in a manner to ensure:

- Risks are appropriately identified and managed.
- Interaction with the various governance groups occurs as needed.
- Significant financial, managerial, and operating information is accurate, reliable, and timely.
- Employees’ actions are in compliance with policies, standards, procedures, and applicable laws and regulations.
- Interactions and arrangements with third parties, including contractors and joint ventures, are in compliance with policies, standards, procedures, and applicable laws and regulations.
- Resources are acquired economically, used efficiently, and adequately protected.
- Programs, plans, and objectives are achieved.
- Quality and continuous improvement are fostered in the organization’s control process.
- Legislative or regulatory compliance issues impacting the organization are recognized and addressed appropriately.

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13 Sample audit activities charter prepared by The IIA; there is a second sample audit charter for audit committees available at The IIA’s website.
Additional consulting services may be provided where consistent with the mission of the internal audit department. Such consulting services will generally be related to assessing the impact of changes being considered or implemented in the organization’s risk management, control, and governance processes.

Opportunities for improving management control, profitability, and the organization’s image may be identified during audits. They will be communicated to the appropriate level of management.

### Accountability

The chief audit executive (CAE), in the discharge of his/her duties, shall be accountable to management and the audit committee to:

- Provide coverage of the adequacy and effectiveness of the organization’s processes for controlling its activities and managing its risks in the areas set forth under the mission and scope of work.
- Report important issues related to the processes for managing risk and controlling the activities of the organization and its affiliates, including potential improvements to those processes, and provide information concerning such issues through resolution. This includes coverage of risk management and governance practices.
- Periodically provide information on the status and results of the annual audit plan and the sufficiency of department resources. This includes ensuring the resources are sufficient in amount and competency, through in-house staff and cosourcing, to cover the risks in the annual audit plan.
- Coordinate with and provide coverage of other control and monitoring functions (risk management, governance, compliance, security, legal, ethics, environmental) and the external audit.
- Establish a follow-up process to track and monitor the effective implementation of management actions related to important issues and recommendations.
Independence and Objectivity

To provide for the organizational independence of the internal audit department and the objectivity of its personnel, internal audit personnel report to the CAE, who reports functionally to the audit committee and administratively to the CEO. The CAE shall be an officer of the organization. Internal audit will include as part of its reports to the audit committee a report annually on the independence of internal audit and any unwarranted restrictions on internal audit scope, communications, access, and resources, including personnel and externally contracted resources.

Because of the importance of audit committee visibility to internal audit to support independence and objectivity of the internal audit activity, the audit committee should be involved in:

- Approving the internal audit charter.
- Approving the risk-based internal audit plan.
- Receiving communications from the CAE on the internal audit department’s performance relative to its plan and other matters.
- Approving decisions regarding the appointment and removal of the CAE.
- Deciding the CAE’s performance evaluation and compensation.
- Making appropriate inquiries of management and the CAE to determine whether there are inappropriate scope or resource limitations.

Responsibility

The CAE has the responsibility to:

- Develop a flexible annual audit plan using an appropriate risk-based methodology, including any risks or control concerns identified by management, and submit that plan along with any subsequent periodic changes to senior management and the audit committee for review and approval.
- Align internal audit coverage with the organization’s strategic, operational, compliance, and financial risks, including important areas of emerging risk.
- Implement the annual audit plan, as approved, including, as appropriate, special tasks or projects requested by management and the audit committee.
- Maintain professional internal audit resources with internal audit staff.
and, where appropriate, other internal or external resources with sufficient knowledge, skills, experience, and professional certifications to meet the requirements of this charter.

- Evaluate and assess important merging/consolidating functions and new or changing services, business units, processes, systems, operations, and control processes coincident with their development, implementation, and/or expansion.
- Issue periodic reports to the audit committee and management summarizing results of audit activities.
- Keep the audit committee informed of emerging trends and successful practices in internal audit.
- Provide internal audit measurement goals and results to the audit committee.
- Assist as appropriate in the investigation of suspected fraudulent activities within the organization and notify management and the audit committee of the results.
- Consider the scope of work of the external auditors and regulators, as appropriate, for the purpose of providing optimal audit coverage to the organization at a reasonable overall cost.
- As appropriate, provide consulting and advisory services to management that add value and improve an organization’s governance, risk management, and control processes without the internal auditor assuming management responsibility.
- Execute a quality assurance and improvement program (QAIP) by which the CAE assures effective operation of internal audit activities and annually report the results of the program to the audit committee.

**Authority**

The CAE is authorized to:

- Ensure the internal audit personnel and contracted resources have unrestricted access to all functions, records, property, and personnel.
- Have full and free access to the audit committee.
- Allocate resources, set frequencies, select subjects, determine scope of work, and apply the techniques required to accomplish audit objectives.
- Obtain the necessary assistance of personnel in units of the organization or
those contracting with the organization where they perform audits, as well as other specialized services from within or outside the organization.

- Provide consulting services to management as deemed appropriate.

The CAE and internal audit personnel are not authorized to:

- Perform any operational duties for the organization or its affiliates.
- Initiate or approve accounting transactions external to the internal audit department.
- Direct the activities of any organization employee not employed by the internal audit department, except to the extent such employees have been appropriately assigned to internal audit teams or to otherwise assist the internal auditors.

Standards of Internal Auditing

The internal audit profession is covered by the International Professional Practices Framework of The Institute of Internal Auditors. This framework includes mandatory elements consisting of the Definition of Internal Auditing, the Code of Ethics, and the International Standards for the Professional Practice of Internal Auditing. The internal audit department will meet or exceed these mandatory requirements of the profession.

The CAE will annually discuss with the audit committee the results of the internal audit QAIP by which the CAE assures effective operation of internal audit activities.

Chief Audit Executive ________________________________________________

Chief Executive Officer ______________________________________________

Audit Committee Chair ______________________________________________

Date ______________________________________________________________
Appendix – The Internal Audit Capability Model for the Public Sector

The Internal Audit Capability Model (IA-CM) concept originated from the Public Sector Committee of The IIA. The research was sponsored by The IIA Research Foundation (IIARF), and the model was published in 2009. The IA-CM is a framework that identifies the fundamentals needed for effective internal audit in government and the broader public sector. It illustrates the levels and stages through which an internal audit (IA) activity can evolve as it defines, implements, measures, controls, and improves its processes and practices.

There are five levels of capability for each essential element of an IA activity. Each level has its own set of characteristics for its associated key process areas (KPAs). The graphic and chart below illustrate the characteristics of the IA activity for each level.

The Internal Audit Capability Model Levels
<table>
<thead>
<tr>
<th>Level</th>
<th>Description</th>
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</thead>
</table>
| 5 – OPTIMIZING | • IA is a learning organization with continuous process improvements and innovation.  
• IA uses information from inside and outside the organization to contribute to achieving strategic objectives.  
• World-class/recommended/best practice performance.  
• IA is a critical part of the organization’s governance structure.  
• Top-level professionals and specialized skills.  
• Individual, unit, and organizational performance measures are fully integrated to drive performance improvements. |
| 4 – MANAGED | • IA and key stakeholders’ expectations are in alignment.  
• Performance metrics are in place to measure and monitor IA processes and results.  
• IA is recognized as delivering significant contributions to the organization.  
• IA functions as an integral part of the organization’s governance and risk management.  
• IA is a well-managed business unit.  
• Risks are measured and managed quantitatively.  
• Requisite skills and competencies are in place with a capacity for renewal and knowledge sharing (within IA and across the organization). |
| 3 – INTEGRATED | • IA policies, processes, and procedures are defined, documented, and integrated into each other and the organization’s infrastructure.  
• IA management and professional practices are well established and uniformly applied across the IA activity.  
• IA is starting to align with the organization’s business and the risks it faces.  
• IA evolves from conducting only traditional IA to integrating as a team player and providing advice on performance and management of risks.  
• Focus is on team building and capacity of the IA activity and its independence and objectivity.  
• Generally conforms to the *Standards*. |
There are six essential elements of an IA activity. The first four elements relate primarily to the management and practices of the IA activity itself. The last two elements include the IA activity’s relationship with the organization that it supports, and the internal and external environments.

The six essential elements are as follows:

- **Services and Roles of Internal Audit** – The services include the provision of assurance and advice as well as cosourced services with external service providers. The role is to provide independent and objective assessments to assist the organization in accomplishing its objectives and improve operations.

- **People Management** – The process of creating a work environment that enables people to perform to the best of their abilities. People management includes job descriptions, recruiting, performance standards, professional...
development, training, ongoing coaching, and career development.

- **Professional Practices** – Reflects the full backdrop of policies, processes, and practices that enables the internal audit activity to be performed effectively and with proficiency and due professional care.

- **Performance Management and Accountability** – Refers to the information needed to manage, conduct, and control operations of the internal audit activity and account for its performance and results.

- **Organizational Relationships and Cultures** – Includes the organizational structure and the internal management and relationships within the internal audit activity itself as well as the audit executive’s relationship with senior management.

- **Governance Structures** – The audit executive’s reporting relationship (administrative and functional), and how the internal audit activity fits within the entity’s organizational and governance structure.

Within each of the six essential elements of the IA activity, there are several KPAs. These building blocks determine the capability of an IA activity. KPAs are the actions or items that should be in place to move up to the next level of capability. Each KPA consists of a purpose, essential activities, outputs, outcomes, and institutionalizing practices. KPAs at each level in each element build upon one another and establish the foundation for implementing a KPA at a higher level.

The following page shows the IA-CM matrix with all levels of capability, essential elements of IA, and their associated KPAs.
## Internal Audit Capability Model Matrix

<table>
<thead>
<tr>
<th>SERVICES AND ROLE OF IA</th>
<th>PEOPLE MANAGEMENT</th>
<th>PROFESSIONAL PRACTICES</th>
<th>PERFORMANCE MANAGEMENT AND ACCOUNTABILITY</th>
<th>ORGANIZATIONAL RELATIONSHIPS AND CULTURE</th>
<th>GOVERNANCE STRUCTURES</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Level 5 – Optimizing</strong></td>
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<tr>
<td>IA Recognized as Key Agent of Change</td>
<td>Leadership Involvement With Professional Bodies Workforce Projection</td>
<td>Continuous Improvement in Professional Practices Strategic IA Planning</td>
<td>Public Reporting of IA Effectiveness</td>
<td>Effective and Ongoing Relationships</td>
<td>Independence, Power, and Authority of the IA Activity</td>
</tr>
<tr>
<td><strong>Level 4 – Managed</strong></td>
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<tr>
<td>Overall Assurance on Governance, Risk Management, and Control</td>
<td>IA Contributes to Management Development IA Activity Supports Professional Bodies Workforce Planning</td>
<td>Audit Strategy Leverages Organization’s Management of Risk</td>
<td>Integration of Qualitative and Quantitative Performance Measures</td>
<td>CAE Advises and Influences Top-level Management</td>
<td>Independent Oversight of the IA Activity CAE Reports to Top-level Authority</td>
</tr>
<tr>
<td><strong>Level 3 – Integrated</strong></td>
<td>Advisory Services Performance/ Value-for-Money Audits</td>
<td>Team Building and Competency Professionally Qualified Staff Workforce Coordination</td>
<td>Quality Management Framework Risk-based Audit Plans</td>
<td>Performance Measures Cost Information IA Management Reports</td>
<td>Coordination With Other Review Groups Integral Component of Management Team</td>
</tr>
<tr>
<td><strong>Level 2 – Infrastructure</strong></td>
<td>Compliance Auditing</td>
<td>Individual Professional Development Skilled People Identified and Recruited</td>
<td>Professional Practices and Processes Framework Audit Plan Based on Management/ Stakeholder Priorities</td>
<td>IA Operating Budget IA Business Plan</td>
<td>Managing Within the IA Activity</td>
</tr>
<tr>
<td><strong>Level 1 – Initial</strong></td>
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</tr>
<tr>
<td>Ad hoc and unstructured; isolated single audits or reviews of documents and transactions for accuracy and compliance; outputs dependent upon the skills of specific individuals holding the position; no specific professional practices established other than those provided by professional associations; funding approved by management, as needed; absence of infrastructure; auditors likely part of a larger organizational unit; no established capabilities; therefore, no specific key process areas.</td>
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Supplemental Guidance: Implementing a New Internal Audit Function in the Public Sector

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GLOBAL HEADQUARTERS
247 Maitland Ave.
Altamonte Springs, FL 32701 USA

T: +1-407-937-1111
F: +1-407-937-1101
W: www.globaliia.org